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Summer 1988

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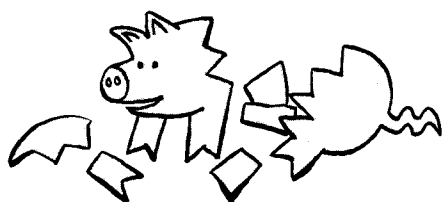
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Who Should Pay for Long-Term Care for the Elderly?

**Alice M. Rivlin
and Joshua M. Wiener**
*with Raymond J. Hanley
and Denise A. Spence*

IT IS TIME for Americans to face a serious problem — how to organize and pay for long-term care for the disabled elderly. More and more Americans are living past 75, 85, and even 95. Consequently, many more elderly than ever before suffer not only acute illness requiring hospitalization and a doctor's care, but also chronic disabling conditions that require long-term care either at home or in nursing homes.

Alzheimer's disease, osteoporosis, heart disease, and stroke predominate among the many diseases that cause chronic disability among the elderly. These conditions bring both physical and emotional pain as people experience and relatives watch a decline in the ability to do things that most of us take for granted. Long-term care is the help needed to cope, and sometimes to survive, when physical or mental disabilities impair the capacity to perform the basic activities of everyday life, such as eating, toileting, bathing, dressing, and moving about.

The United States does not now have, either in the private or the public sectors, satisfactory mechanisms for helping people anticipate and pay for long-term care. The disabled elderly and their families find, often to their surprise, that neither private insurance nor Medicare covers the costs of long-term care to any significant extent. The disabled elderly must rely on their own resources or, when these have been exhausted, turn to welfare. The aging of the baby boom generation combined with rapidly falling mortality rates for the elderly will lead to sharply increased demand for long-term care that will require substantially greater public and private spending far into the next century. Before additional stress is put on this inadequate system, Americans should carefully consider alternative ways of financing long-term care and what role the federal government might play in them.

How Do We Pay Now?

Most elderly people are not disabled. Of the 28.6 million Americans aged 65 and over in 1985, less than a quarter — 6.3 million — were disabled. But the incidence of disability is high for the very elderly. Only about 13 percent of people aged 65–74 were disabled in 1985, but that proportion rises to 58 percent for people aged 85 and over (see figure 1). Mortality rates at advanced ages have come down dramatically in recent years, bringing increases in the number of disabled elderly.

Most disabled elderly are cared for at home, which is where they greatly prefer to be. Caregivers are usually relatives — generally spouses, daughters, or daughters-in-law — and occasionally friends. This unpaid care, which frequently puts great strain on families, is sometimes supplemented by paid

Alice M. Rivlin and Joshua M. Wiener, senior fellows in the Brookings Economic Studies program, and Raymond J. Hanley and Denise A. Spence, senior research analysts at Brookings, are the authors of Caring for the Disabled Elderly: Who Will Pay, from which this article is drawn. Sheila E. Murray provided research assistance.

services, such as home health workers, homemaking help, adult day care, or respite care. Only about 21 percent of the disabled elderly were in nursing homes in 1985.

Most families who must seek nursing-home care find it beyond their financial reach. The cost of a year in a nursing home averages about \$22,000 and can be much higher. Although families are the predominant providers of long-term care in the United States, nursing homes dominate long-term care financing.

Only a trivial portion of total long-term care bills are now covered by any form of insurance — public or private. The disabled elderly who pay for long-term care do so out of their own or their family's income and assets. They turn to Medicaid, which accounts for 71 percent of government spending on long-term care, if they are poor or have "spent down" their income and assets to levels that make them eligible for this means-tested welfare program. Out-of-pocket spending amounts to a little more than half, and Medicaid to a little less than half, of all expenditures for nursing-home care.

The dominance of private out-of-pocket spending and Medicaid in long-term care finance creates a two-class system of care. Medicaid reimbursement rates are below rates charged private-pay patients. As a result, Medicaid patients tend to receive lower quality care and often find an inadequate supply of services and waiting lists for admission. The fact that Medicaid normally covers nursing-home care but little home care introduces an institutional bias into the system. Financing long-term care through Medicaid is perceived as demeaning by beneficiaries, especially middle-class beneficiaries who never expected to be on welfare, as inadequate by providers, and as expensive by state and federal taxpayers.

Although the United States has a highly developed private insurance industry and broad social insurance coverage, especially for the elderly, little attention has been paid to ways of financing long-term care. The development of insurance approaches has been inhibited, most likely, by uncertainty arising out of two characteristics of long-term care:

- Because long-term care is needed primarily by the very elderly, a long time is likely to elapse between the time provision for financing could be made and its use. Possible changes in income, inflation, and the risk of disability over this period create major uncertainties both for buyers and sellers of long-term care insurance plans.

- Long-term care is currently provided primarily by relatives. Once financing is available, there is considerable risk that the elderly and their families will make greater use of paid care, especially paid home care.

Whatever the reasons, the United States so far has relied for long-term care financing on a patchwork of private out-of-pocket spending and a severely means-tested welfare program. Pressure on this patchwork system will mount as the population of disabled elderly increases.

Increasing Strains on the System

Over the next several decades, the bill for long-term care is certain to rise rapidly. Using the Brookings-ICF Long-Term Care Financing Model, we have made detailed projections of the number of disabled elderly to the year 2020, together with their income, resources, and likely use of long-term

care, assuming that mortality rates continue to decline, incomes and inflation continue to grow at moderate levels, and current long-term care financing policies do not change (see figure 2, tables 1 and 2).¹ Four results of these projections are notable.

First, the number of older people will grow rapidly and the number of very elderly will rise even faster. Because more of the population over 65 will be older, more of the elderly will also be disabled. The increase in disabled elderly will mean more users of long-term care, especially nursing-home care. While the number of people over 65 is projected to increase 61 percent over the period, the nursing home population will increase 76 percent. Nursing-home residents will also be older — 51 percent of them will be over 85 in 2018, compared with 42 percent in 1988.

Second, older people will be significantly better off financially by 2020, but the income and assets of the younger elderly will increase much more rapidly than those of the very old. Real incomes of people aged 65–74 will more than double over the three decades due to more and higher pensions, increases in Social Security benefits and income from assets. Incomes of the 85-and-over group, who are most likely to be users of nursing homes and home care, will go up only about 17 percent in real terms. This group is already in its fifties and will not benefit as much as younger groups from expected increases in pension availability and labor force participation by women.

Third, spending for long-term care will increase rapidly, especially for nursing homes. If nursing-home costs rise 5.8 percent a year (compared with a 4.0 percent annual increase assumed for the general price level), nursing-home spending for the elderly will triple, rising from \$33 billion in 1988 to \$98 billion (in constant 1987 dollars) by 2018.

Finally, Medicaid spending will rise faster than total long-term care spending, and the proportion of nursing-home patients dependent on Medicaid will not decline. This last result is surprising. Since the overall economic well-being of the elderly is expected to improve substantially over the period, why should they not become less dependent on a program intended for the poor? The answer is that long-term care costs are projected to rise faster than the incomes of the very elderly, the group most likely to use long-term care. Thus those with the greatest risk of needing care will actually be worse off in the future in terms of their ability to pay for it than the same group is today.

Options for the Private Sector

There are a variety of alternative ways that long-term care might be financed in the future. We focused first on several widely discussed private sector initiatives, including:

- increasing incentives for private saving by creating *individual medical accounts*, savings accounts earmarked for long-term care that would receive favorable tax treatment by the federal government;

- increasing the ability of older people to use the equity accumulated in their homes — normally their principal asset — to pay for long-term care through *home equity conversions*;

- pooling the risk of high long-term care expenses

"The disabled elderly must rely on their own resources or, when these have been exhausted, turn to welfare. . . .

Americans should carefully consider alternative ways of financing long-term care. . . ."



through private long-term care insurance;

- establishing continuing care retirement communities, or residential complexes with independent living units for older people and a guaranteed availability of care, from occasional home care to full nursing-home care if needed, for the lifetime of residents;

- forming social/health maintenance organizations, an extension of the health maintenance organization concept of prepaid health care financing to include long-term care services.

In projecting the potential market for private sector initiatives for the next three decades, we made optimistic assumptions about the number of people who would participate in the various options. Our purpose was to determine the most that can reasonably be expected from the private sector with respect to participation, propor-

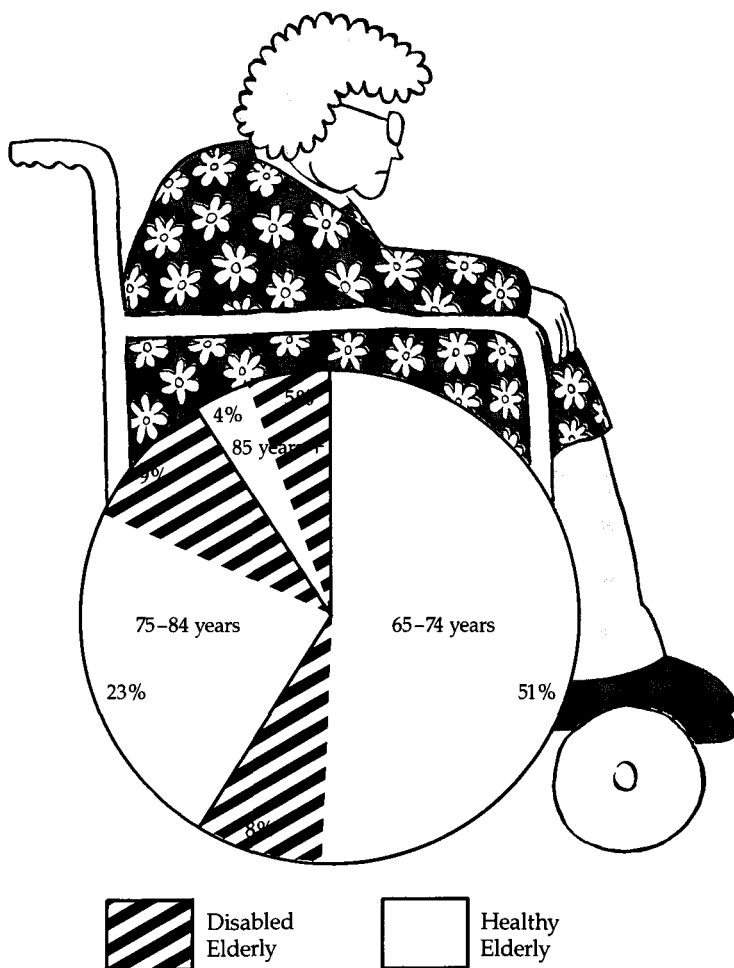
tion of long-term care expenses financed, and reduction in the use of Medicaid.

Our projections indicate substantial potential for growth of private sector financing mechanisms for long-term care. A potential multibillion dollar market is almost entirely untapped. People purchasing these products will have better financial protection.

Even under our optimistic assumptions about who would participate, however, private sector financing cannot be relied on to do the whole job. Private sector approaches are unlikely to be affordable by a majority of the elderly, to finance more than a modest proportion of total nursing-home and home-care expenditures, or to have more than a small impact on Medicaid expenditures and the number of people who spend down to Medicaid financial eligibility levels (see box, p. 8). For example, we

Figure 1. Disabled and Healthy Elderly Populations by Age, 1985

Sources: National Center for Health Statistics; Current Population Reports.



estimate that by 2018, private long-term care insurance sold to those aged 65 and older is likely to be affordable by no more than 25–45 percent of the elderly, to account for 7–12 percent of total nursing-home expenditures, and to reduce Medicaid expenditures and the number of Medicaid nursing-home patients by 1–5 percent. Those general conclusions also apply to social/health maintenance organizations, continuing care retirement communities, and individual medical accounts. Home equity conversions and private insurance sold to people under age 65 are the only options in which a substantial majority of the elderly might participate. However, home equity conversions have limited potential for paying large long-term care bills directly, and 30 years from now private insurance sold to people under age 65 might pay only 17 percent of nursing-home expenditures.

Private sector options have a modest impact because they are so expensive that most of the elderly cannot afford them. Since total long-term care expenditures per capita aged 65 and over exceed \$1,300 a year, this is hardly surprising. Thus, costs never become trivial even when spread over the whole elderly population.

Group insurance, especially if sold to the non-elderly population, could lower premiums by reducing marketing and administrative costs and by allowing people to pay premiums over their entire working careers. Although employers are increasingly interested in offering long-term care insurance, they seem unwilling to help pay for it. Employers face some tax barriers to prefunding these benefits, and premiums for group policies can still be fairly high, even for young people.

Although private long-term care insurance policies are evolving rapidly, policies available now are limited in the amount of financial protection they offer. For example, policies often have prior hospitalization requirements, preexisting condition exclusions, age restrictions on who may purchase policies, and limits on the levels of nursing-home care covered. Very little home care is covered. Reimbursement levels usually do not increase with inflation, which can be a serious problem because a payment level that is adequate today will not be adequate in the future. An indemnity policy with a \$50-a-day nursing-home benefit purchased at age 65 needs to pay over \$150 a day at age 85 to have comparable purchasing power. The problem is that improved coverage is likely to make products more expensive, thus reducing affordability. For example, indexing the indemnity level to inflation would probably increase premiums by about 30–40 percent.

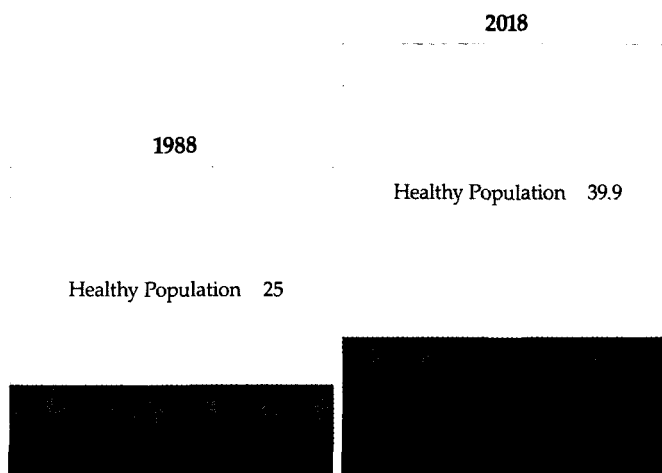
Options for the Public Sector

While it would be desirable for the private sector to play a much greater role in financing long-term care, our projections indicate that private initiatives are not likely to reduce substantially Medicaid spending for long-term care or to decrease appreciably the number of lower- and middle-income people who spend down to Medicaid eligibility. The question then is: should the nation stick with a means-tested welfare program as its major public program for financing long-term care or should it enact a new program of social insurance?

The principal argument for staying with Medicaid is that

Figure 2. Projected Increases In Use of Long-Term Care, 1988 to 2018 (in millions)

Source: Brookings-ICF Long-Term Care Financing Model.



despite its many deficiencies, the program does meet the most urgent needs of the low-income disabled elderly population at minimal cost to taxpayers. The spend-down requirements ensure that Medicaid finances only that part of the care that is beyond the resources of the elderly. While targeted on the poor, Medicaid also provides a safety net for middle-income people with high long-term care expenses.

Making the Medicaid means test less onerous and reimbursement rates more adequate would make life better for the elderly. Desirable changes include increasing the personal needs allowance and the level of protected assets for patients and raising the amount a Medicaid patient's spouse is allowed to retain for living expenses.

Although incremental improvements in Medicaid are attractive and not inconsistent with more fundamental restructuring of the public role in financing long-term care, the welfare character of the program would not change. Public charity always carries some stigma, and efforts to reduce taxpayer costs — which are certain to rise over the next three decades — are likely to perpetuate a two-class system with inferior care and status for Medicaid patients. Moreover, most people who enter nursing homes end up on Medicaid. In other U.S. welfare programs, such as Aid to Families with Dependent Children and Supplemental Security Income, only a small minority of the population is expected to be financially eligible.

It would be greatly preferable to recognize that long-term care is a normal, insurable risk for the elderly, which should be covered under a general social insurance program like Medicare and not through a welfare program like Medicaid. Everyone should contribute to public long-term care insurance and earn the right to benefits when they are needed without having to prove impoverishment. The most straightforward approach to federal financing of long-term care is to add long-term care benefits to Medicare. Social insurance coverage, however, should not make long-term care free, or even nearly free, to Medicare beneficiaries. Substantial cost-sharing is appropriate to control increases in service use that might occur if financing were newly available to the large number of disabled elderly who do not now receive paid care. Indeed, with respect to home care, where the likelihood of increased service use is far greater than for nursing-home care, limitation of benefits to the severely disabled, strictly defined, would also be desirable.

Two basic approaches to public insurance should be considered; each implies a different kind of reliance on the private sector:

— Coverage of nursing-home and home care under Medicare that provides basic protection for elderly people who become disabled, but with substantial cost-sharing for all users, regardless of length of use. The basic model is the current Medicare program. The role of private sector financing would be supplementary — to provide greater protection for those who desire it.

— Reliance on a greatly expanded market for private insurance to provide affordable long-term care coverage for a defined period (one to two years) with the public insurance covering costs of care for patients who require care beyond the defined period. This approach requires a substantial faith in the private sector and leaves the federal government with the role of providing coverage for truly catastrophic costs, retaining a residual Medicaid program,

Table 1. Projected Income and Assets of the Elderly (in 1987 dollars)

Age Group	1988	2018
Median Annual Family Income		
65–74	\$10,806	\$23,203
75–84	8,657	14,956
85 and older	6,837	7,999
All elderly	9,314	17,210
Median Family Assets		
65–74	67,764	94,449
75–84	52,106	73,300
85 and older	40,143	58,410
All elderly	59,230	79,050

Source: Brookings-ICF Long-Term Care Financing Model.

Notes: Projections are five-year averages of the periods 1986–1990 and 2016–2020. Family income is joint income for married persons and individual income for unmarried persons. Income of other members of the household with whom the elderly person might live is not included. Income sources are Social Security, pensions, Supplemental Security Income, individual retirement accounts, wages, and asset earnings. Elderly persons without income are included. The projections for median family assets count both home equity and financial assets; the projections include families without assets.

Table 2. Who Will Pay: 30-Year Projections Under Current Policies (billions of 1987 dollars)

Payment Source	1988	2018	% Increase 1988–2018
Nursing Homes Services			
Medicaid	\$14.1	\$46.2	227%
Medicare	0.6	1.6	168
Out-of-pocket	18.3	50.3	176
Total	33.0	98.1	197
Home Care Services			
Medicaid	1.2	2.4	95
Medicare	3.1	7.7	149
Other payers	2.7	7.2	170
Out-of-pocket	1.6	4.6	182
Total	8.6	21.9	154

Source: Brookings-ICF Long-Term Care Financing Model. Figures are rounded.

Notes: Average annual expenditures. Nursing-home and home-care inflation is assumed to be 5.8 percent a year. General inflation is assumed to be 4.0 percent a year; long-term care inflation in excess of general inflation is assumed to be 1.8 percent a year. Other payers include state and local expenditures, social services block grant, Older Americans Act and Veterans Administration home care funds, charity and out-of-pocket expenditures by persons other than the recipient of the service.

How Much Care Can Private Options Finance?

To determine the amount of long-term care expenses that private sector initiatives may be able to cover, we made assumptions about several of the most frequently discussed options and then projected for the year 2018 the number of elderly likely to participate in each option, the percentage of total spending on nursing-home care each option was likely to pay, and the impact each was likely to have on Medicaid spending for nursing-home care.

Private Insurance

We made three sets of assumptions for private long-term care insurance. The first option assumed that all non-disabled individuals and couples aged 67 with \$10,000 or more in assets—not counting their homes—buy policies if the cost of the premiums is 5 percent or less of their income. The policy provides six years of nursing-home care, after a 100-day elimination period, of \$30, \$40, or \$50 a day (in 1986 dollars) depending on what the person can afford. The indemnity benefit level is moderately indexed for inflation for 10 years after initial purchase. A prior hospitalization requirement allows 75 percent of the people who meet the deductible to receive benefits.

The second plan was based on the same policy as the first but assumed that only those who could afford the \$50-a-day benefit option bought policies.

The third option assumed that at age 30 people begin to buy as much nursing-home insurance (in terms of years of care) as they can afford for 1 percent of their income.

Social/Health Maintenance Organizations

Modeled on an existing demonstration site, the social/health maintenance organization plan covers \$7,500 (in 1986 dollars) of long-term care services annually. Policies

are purchased if the cost is less than 5 percent of household income. Disabled persons may purchase policies. Reflecting the organizational development and enrollment barriers, only 50 percent of the elderly who can afford social/health maintenance organizations actually buy policies.

Continuing Care Retirement Communities

These communities are modeled as comprehensive long-term care insurance mechanisms. Physically fit individuals and couples are assumed to join CCRCs if they have 130 percent of the income needed for the monthly payment and if they have enough total assets to pay the entry fee with at least \$10,000 in assets left over. All physically fit elderly and 50 percent of the disabled elderly are able to join CCRCs if financially qualified. Because of the reluctance of the elderly to move, only 50 percent of qualifying individuals and couples are assumed to join CCRCs. Individuals join CCRCs at age 76.

Individual Medical Accounts

The model assumes that 90 percent of individuals at the individual retirement account maximum contribute up to \$1,000 a year to an individual medical account to be used exclusively for long-term care.

Home Equity Conversions

For home equity conversions, the model assumes that all individuals and married couples with \$25,000 or more in home equity take out a home equity loan at age 75. Repayment of the loan is postponed until after the homeowner's death and all appreciation on the home accrues to the mortgage company.

Options	% of elderly participants ¹	% of all nursing-home expenditures paid ²	% of change in Medicaid nursing-home expenditures ³	% of change in number of Medicaid nursing-home patients ⁴
Private insurance				
\$30, \$40, or \$50 benefit	45%	11%	—5%	—5%
\$50 benefit	25	7	—1	—1
purchase under age 65	63	17	—12	—8
Social/health maintenance organizations	26	10	—8	—6
Continuing care retirement communities	18	14	—3	—3
Individual medical accounts	28	3	—1	—2
Home equity conversions	67	na	2	2

Source: Brookings-ICF Long-Term Care Financing Model.

na: not available

1. Because age at initial participation varies by option (see above), the elderly population is different for each option.

2. Total nursing home expenditures vary under each option.

3. Medicaid nursing-home expenditures under the base case are \$46.2 billion.

4. The number of nursing-home patients receiving Medicaid under the base case is 2.34 million.

How Much Will Public Insurance Options Cost?

To illustrate the potential costs of a public long-term insurance program and the taxes needed to pay for them, we modeled two prototype public insurance programs. The moderately comprehensive option would provide nursing-home patients with unlimited coverage of skilled nursing and intermediate care facilities, require a deductible of 100 days and coinsurance of 25 percent, and set reimbursement at 115 percent of the Medicaid rate. Home-care benefits would be limited to persons with three or more problems with activities of daily living; benefits would cover skilled and unskilled services and require a deductible of one month and coinsurance of 20 percent; and reimbursement would be set at 115 percent of the weighted average cost per visit for all noninstitutional services.

The catastrophic insurance option would provide unlimited coverage of skilled nursing and intermediate care facilities, with a deductible of two years and coinsurance of 10 percent; reimbursement would be set at 115 percent of the Medicaid rate. No new home-care benefits would be provided under this option.

The projections for both of these options assume that Medicaid will remain a separate program with no improvements and that current Medicare long-term care benefits will be maintained. The projections further assume a 20 percent increase in nursing-home use. Under the moderately comprehensive option, home-care use and expenditures would increase 50 percent; under the catastrophic insurance option, home-care use would not increase

because home-care services are not covered.

In the following table, total expenditures include all private and public spending for nursing-home and home care; public expenditures include Medicare, Medicaid, and other existing government programs. For comparative purposes, we estimated the average payroll tax required to finance total and public expenditures for the base case, even though those expenditures are not currently financed that way. The base case projects what will happen under current programs and policy. The payroll tax is paid half by the employer and half by the employee; there is no cap on taxable salary.

Option	Expenditures (billions of 1987 dollars)		Average Payroll Tax 1988–2050
	1988	2018	
Total Expenditures			
Base case	\$41.6	\$120.0	2.8%
Public Expenditures			
Base case	21.7	65.1	1.6
Moderately comprehensive option	42.2	122.0	2.9
Catastrophic option	33.4	93.5	2.2

Source: Brookings-ICF Long-Term Care Financing Model.

and subsidizing private insurance for low-and moderate-income elderly.

Either of those approaches is feasible. Public costs and the taxes necessary to pay for a public insurance program would be substantial but need not be unmanageable. The box above presents the assumptions and results of two prototype public insurance programs that we modeled. These simulations are illustrative only and were designed to provide a range of possible costs. Assuming a 20 percent increase in nursing-home use and a 50 percent increase in home-care use, the near-term (1988) average annual public costs of a fully implemented public long-term care insurance would run from \$33 billion to \$42 billion, compared with \$20 billion under current policies.

A payroll tax of between 2.2 percent and 2.9 percent, half on employers and half on employees with no cap on taxable salaries, would be required to finance the program. If current public long-term care programs were financed by a payroll tax, the cost would amount to 1.6 percent of payroll. The incremental tax can and should be reduced through estate or inheritance taxes, income tax surcharges, or excise taxes; through premiums paid by the elderly; or by retaining some state financial responsibility for long-term care.

Major new initiatives are needed in both the private and public sectors to improve the financing of long-term care. Americans should recognize that long-term care is a

normal risk of growing old that needs to be anticipated. A large potential market exists for private long-term care insurance and other private initiatives. Development of that market by the private sector with encouragement from the government could make long-term care much more affordable for a substantial fraction of the population. However, even with maximum likely development of private options, public spending for long-term care, mostly under Medicaid, will increase rapidly for the foreseeable future. Since continued reliance on a welfare program to finance long-term care for a large part of the population is undesirable, ways should be found to broaden Medicare coverage to include long-term care. Any such program should leave a substantial role for the private sector.

Although financing long-term care has traditionally been viewed as an insoluble problem, it is actually one of the more tractable social issues facing the United States. Unlike crime, poverty, racism, and teenage pregnancy, financing long-term care has a range of known and feasible solutions. The question is whether we as a society have enough political will and ingenuity to choose among them and put an improved system in place.

1. The Brookings-ICF Long-Term Care Financing Model was jointly developed by Brookings and ICF Incorporated, a consulting firm based in Washington, D.C.

The Value-Added Tax

Sorting Through the Practical and Political Problems

Henry J. Aaron

CHAMPIONS OF THE VALUE-ADDED TAX have been touting its virtues for more than two decades. They have claimed at alternative times that replacing other taxes with a VAT would simplify taxation and improve economic efficiency, enhance international competitiveness of the United States, and increase private saving. Some of the supposed benefits are exaggerated or illusory. It is hard, for example, to understand how the addition of a VAT can simplify overall tax administration and compliance unless it entirely replaces one or more existing taxes. Other arguments are indisputably correct. Shifting the focus of taxation from income to consumption would clearly reduce the bias in the current system that favors current consumption over future consumption. Whatever one may think of these contentions, the mass of tax practitioners and of the general public remained unpersuaded that any potential advantages justified the trouble of introducing a new tax.

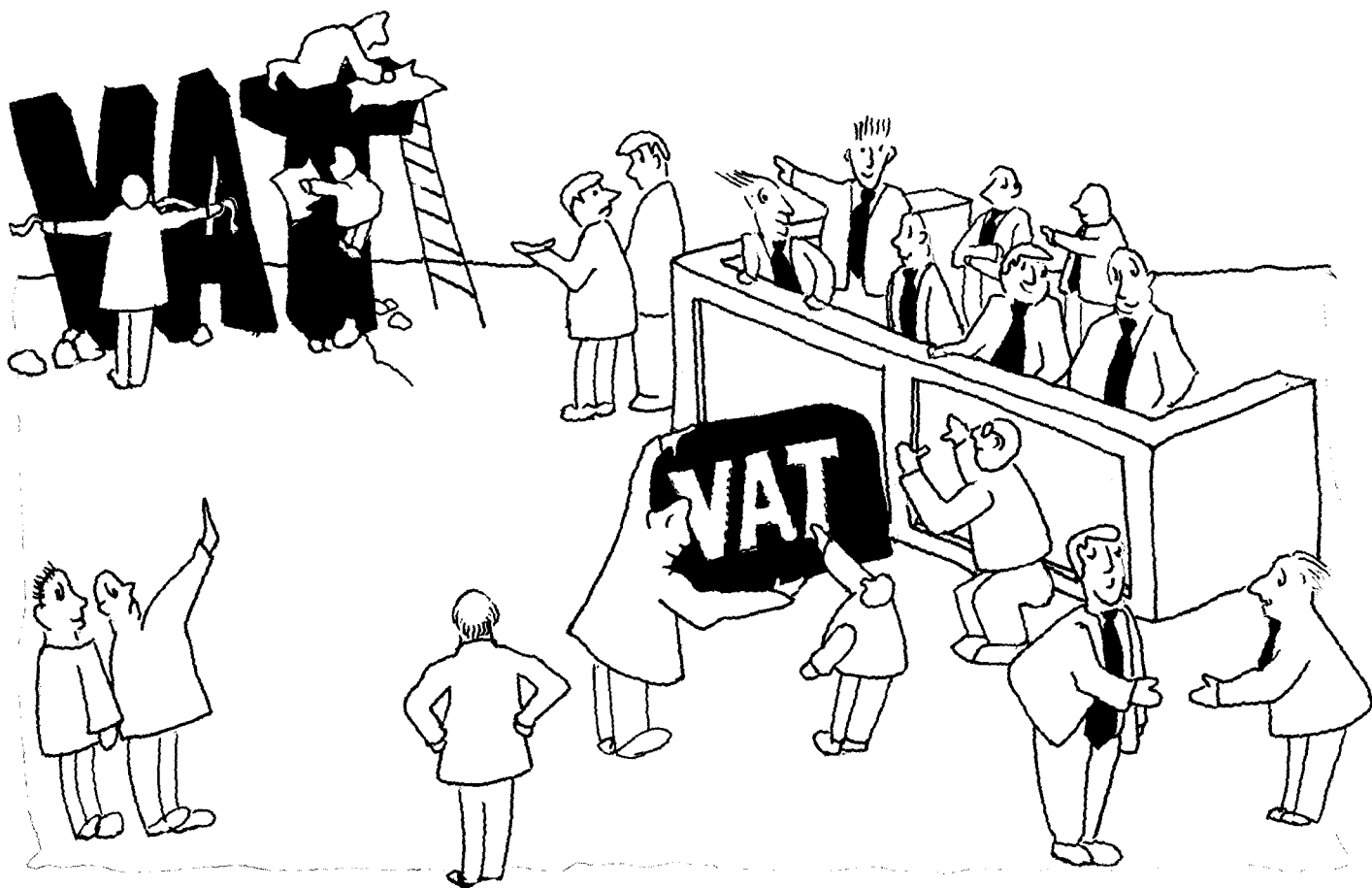
That enactment of a VAT is being widely discussed now is attributable to the huge current and projected federal deficits. Normal discussions of tax structure have been supplemented by a search for the politically least odious way to increase federal revenues.

The Congressional Budget Office currently projects that the comprehensive annual budget deficit will decline from about \$157 billion in 1988 to roughly \$134 billion in 1993. These estimates allow for the effects of the two-year deficit-reduction compromise to which Congress and the president agreed in late 1987. However, the projections greatly underestimate the actual deficit for two reasons.

First, they include as offsets to even larger deficits elsewhere in the federal budget the large Social Security surpluses that will result from the congressional decision to try to prepay part of the formidable cost of Social Security benefits that the baby-boom generation will impose when it retires next century. If these surpluses are to serve that long-run purpose, they must be used to expand national saving, not to finance current government consumption. For this reason, these surpluses should be excluded from estimates of the federal deficit. When this correction is made, projected deficits rise to \$195 billion in 1988 and to \$231 billion in 1993.

The fiscal problem is even more serious than these numbers suggest for a second reason. The same baby-boomers who will claim pensions on retirement will also demand costly hospital care and physician services. Thus, the same rationale that led Congress to provide for large Social Security surpluses — the impending cost of Social Security benefits for the baby-boom generation — implies that the Medicare program should also be running surpluses. Instead, the Medicare program, which currently is in rough balance, will soon begin to run large deficits that will exhaust accumulated reserves shortly after the turn of the century.

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To provide for the future costs of Medicare in a manner similar to that currently being used for Social Security would require an increase in taxes of about \$50 billion in 1988. This estimate does not include any allowance for the prospective costs of long-term care. Prepaying some of the predictable long-term care costs, as well as those of acute care, would require tax increases well in excess of \$50 billion in 1988 and of even larger amounts in future years. These numbers mean that at least \$50 billion should be added to whatever deficit-reducing tax increases or spending cuts that budget deficits of \$200 billion or more a year would justify.

Experts disagree on how far and how fast that deficit should be reduced. They also disagree about how much of the reduction should be achieved by spending cuts and how much by tax increases. But most recognize that the projected deficits are too large to be cut sufficiently by any combination of politically imaginable expenditure reductions.

Recent budget history suggests that Congress strongly endorses most current federal expenditures and is unwilling to cut them significantly. Forty billion dollars would be a generous — some would say absurdly high — estimate of the most that Congress is likely to cut spending. With heroic effort, Congress might increase excise taxes by perhaps \$30 billion. In the exceedingly improbable event that Congress took both of these steps, additional revenues of about \$75 billion would have to be found to achieve a

deficit in 1988, adjusted for Social Security and Medicare, of \$50 billion.

A more plausible estimate is that taxes, other than excises, will have to be increased at least \$100 billion if the deficit, adjusted for the costs of Social Security and Medicare, is to be reduced to \$50 billion. Increases of this size can be achieved in only two ways: by raising income tax collections — through base broadening or rate increases — or by introducing a new revenue source, such as a value-added tax or a national retail sales tax.

A boost in personal and corporate income taxes of just over three percentage points in all brackets would generate sufficient revenue. In many ways, such a tax increase would be the simplest, fastest, and fairest way to raise the requisite revenues. In the end Congress may elect to pursue this course. To do so, however, it would have to reconsider questions that bedeviled the tax reform debates in 1985 and 1986 — whether to exclude some part of capital gains from tax or to index them and whether to provide investment incentives to hold down the user cost of capital, for example. Furthermore, members of Congress would face the allegation of bad faith from challengers who could charge that Congress was reneging on rate reduction, the quid pro quo for broadening the tax base in 1986.

To avoid such issues and charges, Congress is likely to consider a VAT, along with income tax increases, if it decides to raise taxes by a large amount. A value-added

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tax falls on the increase in value of output at each stage of production. The type in most common use around the world falls on the difference between the value of output and the cost of goods and services purchased from other companies. In effect, the VAT falls on the sum of labor compensation and all income earned by owners of capital invested in the taxed company. Different countries employ a variety of administrative procedures to collect the tax.

Any large tax increase will be politically controversial, even with farsighted leadership from the White House and Congress. The need to narrow the great gap between government spending and revenue is sufficient to justify endorsement of whichever of these methods of raising taxes has the greater chance of being enacted. Because of our inexperience with and misgivings about a VAT, I shall examine the objections that have been and will be raised against such a tax, appraise their validity, and suggest ways those objections could be met. A similar exercise could be carried out for a major increase in the personal and corporate income taxes, as a large income tax increase poses some similar problems, and these problems also can be solved.

The Practical Problems

A value-added tax of 1 percent would yield between \$13 billion and \$22 billion dollars in 1989, depending on the breadth of the tax base. To raise \$100 billion, therefore, would require a tax of at least 5 to 8 percent. For reasons set forth below, the rate necessary to raise *net* revenues by \$100

billion would have to be higher to allow for concessions made to soften political opposition.

If the next administration and Congress decide to propose a value-added tax, a number of practical and political problems would have to be solved to secure its enactment and to implement it.

—Introducing a VAT would create inflationary pressures. How can they be minimized?

—A VAT, even one that excludes food and housing, will impose onerous, perhaps unfair, burdens on low-income and some elderly households. How can these burdens be minimized or offset?

—State and local governments are reported to oppose the VAT because it would represent federal intrusion on a tax base previously used predominantly by them. What can be done to soften that opposition?

—Administrative experts estimate that it would take 18 to 24 months to put a VAT into effect once it was enacted. Can and should this lag be shortened?

—Many conservatives fear that the addition of a major new revenue source, such as a VAT, would fuel the expansion of the public sector. Is this fear justified, and if so, what can be done to reduce opposition based on it?

Inflation

The introduction of a VAT yielding \$100 billion in 1989 would boost the price of consumption relative to disposable personal income by approximately 3 percent. It is important to recognize that the aggregate size, if not the distribution, of this direct effect on the average taxpayer is the same as that of an increase in income taxes that would yield the same amount of revenues. One tax affects income; the other, expenditure. But the effect on the real aggregate disposable income is the same.

Under current rules, however, an increase in prices attributable to a VAT would directly boost the consumer price index (CPI), while the reduction in disposable income from an increase in income taxes would not. This statement is based on the presumption that a VAT will eventually be reflected fully in increased prices because monetary policy would largely accommodate a VAT-induced jump in prices. Such accommodation is likely because authorities would fear that aggressive use of monetary policy to prevent the introduction of a VAT from raising prices would increase unemployment excessively. To the extent that jumps in the CPI translate into higher wages, introduction of a VAT would cause further increases in prices, while an income tax increase might not.

Although fear of such a tax-price-wage-price spiral stands as a major objection to a VAT or national retail sales tax, this fear is overblown because a straightforward solution is available. The consumer price index could be redefined to remove value-added taxes. In that event, the introduction of a VAT would still cause an initial increase in prices. But this increase would not be propagated automatically through indexing formulas.

Collective or political bargaining might nevertheless lead to reactive increases in wages or transfers. Differences in the distribution of reductions in real incomes under a VAT from those that would result from an increase in income taxes might lead to different political bargains. But, as noted, the size of the overall impact on real disposable

income from equal-yield taxes is identical.

I conclude that a VAT, while likely to cause a small addition to the price level — perhaps 3 percent for a \$100 billion tax — need not add to subsequent inflation.

Burden on the Poor

Critics of the value-added tax point out that it is regressive, by which they mean that the ratio of a consumption-based value-added tax to income measured over a year, or some other similar period, declines as income increases. This observation is indisputable.

It is also highly misleading and oversimplified for several reasons. First, students of consumption have long noted that although the ratio of consumption to income declines with respect to *annual* income, it declines little with respect to *long-term average* income.

The explanation, which has also long been understood, is that annual income is a poor index of long-term economic status. Most households experience considerable income variability. In any given year, the ratio of consumption to income in the bottom income brackets is an average based on the behavior not only of households that are customarily in those brackets, but also of households with normally somewhat higher incomes. Consumption of the latter group is based on their normally higher income and raises the average consumption-income ratio for the entire bottom income bracket.

The top income groups have low ratios of consumption to income in large part for symmetric and opposite reasons. The ratio of consumption to income in the top brackets is dragged down by the consumption behavior of households experiencing abnormally high incomes, but whose consumption is based on their normally lower incomes. Thus, the fact that the ratio of value-added tax to consumption falls with annual income does not necessarily indicate that the tax is regressive based on long-term economic status.

It would be more nearly accurate to describe the value-added tax as proportional with respect to long-term income, because consumption of most households is roughly proportional to long-term income. This statement should be unsurprising, because the consumption of most households roughly equals their lifetime income — wages and salaries, plus interest and other income on savings. This statement holds even for the poor, since cash transfers are included in measures of money income. The one group for which it is untrue is the very rich, who consume less than their income by leaving bequests materially larger than any inheritances they may receive.

Whether or not a VAT falls proportionately on all income groups, it would unquestionably place greater burdens on the poor than would an equal-yield increase in income taxes. This burden is objectionable, but it can be offset for most low-income households by allocating a small part of the revenue from a value-added tax to increases in food stamps, Aid to Families with Dependent Children, Supplemental Security Income, other income-tested transfers, or the earned income tax credit. Virtually all low-income households could be fully protected against the effects of a \$100 billion VAT if income-tested benefits were also raised by roughly \$5 billion, the share of the bottom quintile in \$100 billion of revenues.

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For example, a 10-percent increase in food stamp benefits would approximately offset the effect on households eligible for the full food stamp allotment of a VAT that raised \$100 billion in revenue.¹ Total food stamp costs, projected at just over \$12 billion in 1989, would rise more than 10 percent because additional families would be rendered eligible for assistance and because the percentage increase in benefits for families with outside resources would exceed 10 percent. Another option would be to increase the standard deduction by \$500 a return at a cost of approximately \$3 billion.

To ensure that high-income households that save do not avoid their fair share of the burden of reducing the deficit, the most direct and logical instrument would be an increase in estate and gift taxes. Alternatively, a variety of changes in the personal income tax base or increases in personal or corporate income tax rates could accomplish the same purpose with rough justice.

I have thus far not mentioned the method of reducing the regressivity of a VAT most commonly used in Europe and proposed in the United States — the exclusion from tax of food, housing, and perhaps some other “necessities.” Although superficially appealing, exclusions are badly flawed instruments for dealing with regressivity. This approach cannot shield the poor from the burden of a VAT as fully as personal exemptions and the standard deduction shield them from the effects of an increase in the personal income tax. Furthermore, narrowing the value-added tax base means setting higher tax rates to gain the same amount of revenue that would be raised if these

goods were taxed at a lower rate. The resulting higher rates apply to the remaining consumption of the poor and of all other groups as well. Exempting "necessities" can reduce regressivity but only at the price of seriously complicating administration by requiring sellers to make what are inevitably narrow and arbitrary distinctions.²

It is important to keep in mind that other solutions to the deficit also unduly burden the poor. Cuts in public spending invariably fall directly on beneficiaries of the programs that have been cut and indirectly on suppliers of those services. Across-the-board cuts in Social Security, for example, would directly reduce incomes of households with low-income elderly and disabled beneficiaries. Excise taxes suffer from the flaw of regressivity in a degree similar to that of the VAT.

Impact on the Elderly

The argument has been advanced that introduction of a new tax on consumption would burden retirees more than would an equal-yield increase in income taxes. This argument is based on the contention that retirees finance much of their consumption with savings from past income on which taxes have already been paid. Imposing a new tax on consumption from those savings would represent double taxation.

This argument has some substance, but not much. Most of the income that the elderly receive has not yet been subject to income tax (see table 1). No significant problem of double taxation exists with respect to the first five of these items, which account for 69 percent of total income of the elderly, because personal income tax has not been paid before receipt of these classes of income.³

A problem of double taxation could arise with respect to the portion of income that comes from assets, if the assets were accumulated from previously taxed income. One should keep in mind, however, that asset income represents less than 10 percent of total income for the bottom half of the elderly income distribution. Furthermore, part of asset income consists of interest, dividends, or other income that has not been previously taxed, and

part comes from tax-sheltered savings accounts, such as individual retirement accounts and Keogh plans, which likewise have not been previously taxed. Such payments would, and should, be subject to income tax and hence to any tax increase. Replacing an income tax increase with a tax on consumption could not be regarded as discriminatory.

In addition to cash income, the imputed value of owner-occupied housing would escape the effect both of an increase in income taxes and of a newly introduced VAT.

In short, the introduction of a VAT would subject only a small fraction of the income of the majority of the elderly to double taxation. The difference for the elderly between the burden imposed by a 5 percent VAT and that imposed by an income tax increase yielding the same revenue would be a small fraction of the 3 percent of consumption that either tax would yield. Assets provide a significant portion of income only for the elderly in the top one or two income quintiles, and even then not much of this asset income is subject to double taxation.

The claims that a VAT would excessively burden the poor, insufficiently burden the rich, and be unfair to retirees have limited merit. But these problems can be solved at the bottom of the income distribution by increases in transfer payments and at the top of the income distribution by selective increases in income or estate and gift taxes. The former would cost revenue, while the latter would gain it. Solutions to these problems may be politically difficult, but they are technically easy to design and would cost less than 10 percent of the revenue a VAT would generate.

Intrusion on State, Local Tax Bases

The federal government has made only limited use of specific taxes on commodities and no use at all of general commodity taxes. States and localities have used this tax base extensively and fear that introduction of a federal value-added tax would interfere with their ability to levy general and selective sales taxes (see table 2).

The fact that states and localities have managed to make extensive use of income taxes despite far heavier use by the federal government of the income tax base than any VAT proposal now under discussion would make of the sales tax base suggests that this fear is exaggerated. Because the fear is real, however, it might prove expedient to couple any VAT proposal with provisions attractive to state and local governments.

Such "sweeteners" could take a variety of forms. Among the least costly to the federal government would be to let states exchange their current retail sales taxes and some or all selective commodity taxes for add-on taxes, imposed in addition to the federal VAT, and collected by the federal government, with proceeds returned to the states. States and localities could be accorded wide discretion to set add-on taxes as they wished, provided they accepted the VAT base. Major advantages for states and localities would include improved collections on the rapidly rising value of mail-order sales and the ability to tax many services now effectively outside the range of sales taxes.

Other sweeteners would reduce net federal revenues

Table 1. Sources of Income for the Elderly

Source	Percent of Total Income
Social Security, Railroad Retirement	39%
Private pensions	6
Government employee pensions	7
Earnings	16
Public assistance	1
Assets	28
Other	2

Source: Martynas A. Ycas and Susan Grad, "Income of Retirement-Aged Persons in the United States," *Social Security Bulletin*, vol. 50 (July 1987), table 4, p. 8.

Table 2. State and Local Use of Sales and Commodity Taxes

Type of Tax	Percent of Personal Income in FY 1985
General sales and gross receipts	2.79%
Selective sales	1.39
Motor fuels	0.45
Public utilities	0.33
Insurance premiums	0.15
Tobacco	0.15
Alcoholic beverages	0.11

Source: Advisory Commission on Intergovernmental Relations, *Significant Features of Fiscal Federalism*, 1987 Edition (Washington, D.C., June 1987), tables R-3, R-4, and R-5, pp. 132-34.

from a VAT but might prove more attractive to states and localities. The federal government could allocate a fixed percentage of VAT revenues to a revenue-sharing pool. The recent sacrifice of general revenue sharing on the altar of reduced federal spending might dampen state and local faith in the durability of such a commitment, however. Alternatively, the federal government could increase matching for Medicaid or Aid to Families with Dependent Children, introduce formula grants for elementary and secondary education, or propose other devices for transferring some part of VAT revenues to state and local treasuries.

Each of these approaches adds politically controversial issues to those raised by the introduction of a VAT. But each can compensate state and local governments for federal infringement on a tax base that states and localities use extensively.

Slow Implementation

A VAT is likely to take 12 to 18 months longer to implement than would an increase in income taxes. Even if a new president decides to propose a value-added tax, he is unlikely to do so before late 1989 or early 1990. In the unlikely event that Congress speedily enacted the new tax, the Internal Revenue Service would need 18 months to two years to hire and train new administrators, design rules and forms, and carry out the public education necessary before revenues could actually be collected. No revenues from a VAT could be expected before 1992 or, quite possibly, 1993. If reducing the deficit is sufficiently important to justify a major new tax, is such a delay supportable?

Most of that delay is unavoidable whatever form a proposed tax increase may take, if one assumes that President Reagan will not propose a major tax increase and that Congress will not enact one without White House leadership. Unless an emergency compels immediate action, the next president is likely to spend much of his first year in office deciding how best to deal with the deficit and shaping a political consensus on the chosen course. No

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proposal for a large tax increase of any kind is likely to go to Congress before late 1989, and action there is unlikely at least until 1990. Large increases in revenues, therefore, are unlikely before 1991.

Whether the additional delay for a VAT will then be seen as an advantage or a disadvantage clearly depends on the state of the economy. For example, if a VAT were enacted during a recession, the inducement to spend in advance of a new VAT and the delay in the onset of collections could easily be seen as an advantage. When any major tax increase is at least three years away, it is hard to know what to make of the argument that a VAT should not be considered because implementation would be slow.

Spur to Big Government

The VAT became a major revenue source in the European Economic Community during the 1960s and 1970s. At the same time, the size and scope of government spending increased dramatically. Even if one understands fully the fallacy in *post hoc, ergo propter hoc* reasoning, the coincidence of the new tax and government expansion is bound to suggest some relationship. Either the availability of abundant revenues from the new tax created opportunities for public spending, or officials interested in expanding public spending embraced the value-added tax as the best way to make their fiscal wishes come true.⁴ It is not clear how one who accepts this connection comes to terms with the contraction of the public sector, but not of the VAT, during the 1980s.

Whatever relevance this argument may have had for Europe (or the United States) of the 1960s, the United States of the 1980s and 1990s is altogether different. While policymakers of the 1960s spent many nights devising uses for fiscal dividends spawned by the interaction of rapid economic growth and inflation with an unindexed income tax, their counterparts today and tomorrow must devise ways to prevent current government deficits from absorbing half of national saving and undermining economic growth. Furthermore, the contention that a VAT, once enacted, would be far easier to increase than income taxes are is asserted as if it were self-evident, when in fact there is no current basis for it.

Whatever the reality, the fear that a VAT breeds big government is real, and it is unlikely to be dislodged by argument. Furthermore, it pushes to the foreground a question of great importance — the proper scope of government.

Accordingly, proponents of a VAT have two options. First, they can try to design sweeteners that compensate those who fear large government with something else that appeals to them. For example, some business opposition to a VAT might weaken if a VAT were linked to a reduction in taxes on corporate income or to renewed investment incentives, however hard it may be to justify such incentives on the basis of economics or tax structure.⁵

Second, proponents of a VAT might try to make a virtue of what some see as a flaw, by linking a VAT to a popular government initiative, such as some form of insurance against the costs of long-term care. Either of these courses would prove quite expensive but might soften or override opposition based on the fear that a VAT would lead to an expanded government.

The Political Problem

Much of the debate about the virtues and flaws of the value-added tax turns on whether it would be a good idea to raise the current amount of revenue with a tax system that relies to a greater extent than the current system does on consumption taxes. At various times and places, this debate is worth having. The issue today is quite different. Given the size of the federal deficit, its pernicious long-run effects, and the evident unwillingness of the political system to eliminate the deficit through spending reductions, is there a method of raising taxes that will be politically and economically acceptable?

Any large increase in taxes will have some general undesirable economic side-effects. In this sense, the VAT and an equal-yield increase in income taxes have much in common. Most of the specific objections to a VAT have some basis. Even if one prefers an increase in income taxes to the introduction of a VAT — as I do — one should recognize that all of these objections can be answered by companion proposals. Most of these proposals carry a price and would cut into the net revenues that could be raised by a VAT. On balance, it seems likely that a broad-based VAT of 7–8 percent with accompanying sweeteners would be necessary to net as much revenue as an unadorned 5 percent VAT would generate.

This line of reasoning suggests that the major task in designing an enactable VAT is not the details of the tax itself. This problem is technically undemanding, and the solutions are widely understood. The subtle and difficult problem is designing the companion legislation to mold a political coalition at reasonable cost.

1. This estimate is based on the fact that \$100 billion will be approximately 3 percent of consumption in 1989 and that food is estimated to absorb about 30 percent of the budget in estimates of poverty thresholds.

2. The French experience with a VAT that has a normal rate, a higher rate, and a lower rate illustrates the problems that cannot be avoided once a VAT is imposed at more than a single rate. "The . . . reduced rate is applicable to foods (except beverages other than water and milk), including candy, margarine, and vegetable fat; products used in agriculture; passenger transportation; nonpornographic entertainment; books; residential rents; and meals served on the job. The increased rate is applied to cameras, radios, recording equipment, automobiles and motorcycles, furs, jewelry, perfume, tobacco, and pornographic entertainment. . . . To illustrate the anomalies, books are taxed at reduced rates, records at the increased rate; pastry is taxed at the reduced rate, fruit juice at the normal rate; radios are taxed at the increased rate, television sets at the normal rate; alcoholic beverages are taxed at the normal rate, tobacco at the increased rate." Jean-Pierre Balladur and Antoine Coutière, "France," in Henry J. Aaron, ed., *The Value-Added Tax: Lessons from Europe* (Brookings, 1981), pp. 20, 21.

3. A small portion of Social Security benefits represents the return of the employees' payroll taxes on which personal income tax has already been paid. For no retiree does this component of Social Security exceed 15 percent of the actuarial value of benefits.

4. Actually, the VAT in most European countries replaced older turnover, wage, or sales taxes and was not so much a new revenue source as it was a reformed or rationalized revenue source.

5. The Committee for Economic Development first proposed such a linkage more than 20 years ago.

An Open Trade Alternative for the Next President

Robert J. Morris

ADVICE TO THE NEXT American president flies thick and fast during an election year and becomes positively deafening after the first Tuesday in November. This year has already seen more than its share of proposals for a new trade policy. The debate has centered on two main issues. The first is how vigorously or automatically United States law should require "retaliation" if other countries fail to open their markets rapidly enough to our exports or to correct their trade surpluses with us. The second issue concerns the extent to which we should continue to base our policy mainly on the traditional multilateral, nondiscriminatory principles embodied in the General Agreement on Tariffs and Trade (GATT). Many in both Congress and the private sector argue that we should differentiate among our trading partners, treating some more favorably than others or basing our treatment of each on newly defined concepts of reciprocity, either by trading regime or by sector.

As tempting as the one-dimensional strategies already proposed may be, none will solve the problems that will confront the president who takes office next January. Instead, he needs a coherent policy that uses several available — and a few new — instruments, institutions, and initiatives to produce a trade policy structure advantageous not just to Americans but to the world as a whole. That framework can be built, but not with the blunt-instrument approaches advocated by the authors of "get tough" unilateralism (much but not all of which was rejected by the congressional drafters of the trade bill President Reagan vetoed), or with the cavalier dismissal of multilateralism that seems to pass for sophisticated analysis in many of the prescriptions. However, before getting to the components of a workable strategy, we should be sure that we understand the nature of the problems and challenges the new president will face.

Threats to Prosperity

The most serious challenges to future American prosperity are the rise of the mercantilist ethic as the driving force behind both trade and economic policy, mainly abroad but increasingly in the United States as well, and protectionism, as rooted in current practices everywhere but as a more overt threat in the United States. Allowing either of these forces to prevail as we move into the last decade of this century would be a tragedy of historic proportions, comparable to the last time they gained the ascendancy in U.S. policy in 1930. To overcome the threats to prosperity that they pose is one of the most important challenges facing the new administration and the 101st U.S. Congress in 1989.

Germany, France, and Japan have traditionally been the prime exponents of the mercantilist ethic, though other European nations and, more recently, other Asian countries such as Taiwan have been equally dedicated to its principles, if

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not always as successful in implementing them. By elevating a trade or current-account surplus to the status of an overriding national objective, such countries have effectively excused themselves from any obligations to pursue economic policies that would promote the domestically led growth and structural adjustment needed to reduce their external surpluses. These surpluses are the counterparts of the massive U.S. deficit and are equally, and perhaps even more, dangerous to the stability of the world economy. If these countries fail to act upon their obligations as surplus countries, they will be just as responsible for the deterioration of an open world trade system as those that may be tempted into protectionism out of frustration.

Protectionism is the more obvious challenge to prosperity. Whether it takes its traditional form of direct barriers to imports or to investment by foreigners or its more subtle expression of keeping particular industries going on life-support systems fueled by government subsidies, protectionism is always "financed" by the consumers of the protected products and by the protecting economy's dynamic, job-creating industries. Trade barriers may be aimed at foreign producers, but their real victims

are all the unprotected domestic competitors for labor, capital, and material resources — the very industries upon whose success the nation relies to provide a prosperous and competitive future. Though some protection may occasionally be justified to promote adjustment, ensure national security, or enforce discipline under internationally agreed trade rules, its costs should be understood and its use seen as a last resort rather than as a policy action of choice or the mindlessly inevitable result of an easily triggered statutory process.

There is an additional reason why protectionism would be especially devastating to the United States at this particular time. In the last few years, the productivity of American industry has improved markedly, prompted in no small measure by the strong dollar of the early 1980s. At the same time, dollar exchange rates have regrouped around levels that have broadly restored the international real price relationships that obtained at the beginning of this decade when the United States last ran a current-account surplus. As a result, American industry is now highly competitive in international markets.

The proof lies in developments in trade flows measured in volume rather than by value. For the last year or so, imports have expanded at rates roughly similar to real growth in the economy while exports have grown about twice as fast. Now would be the worst possible time to implement a protectionist policy that would precipitate trade wars and a collapse of international trade just when American industry is best equipped to exploit world market opportunities.

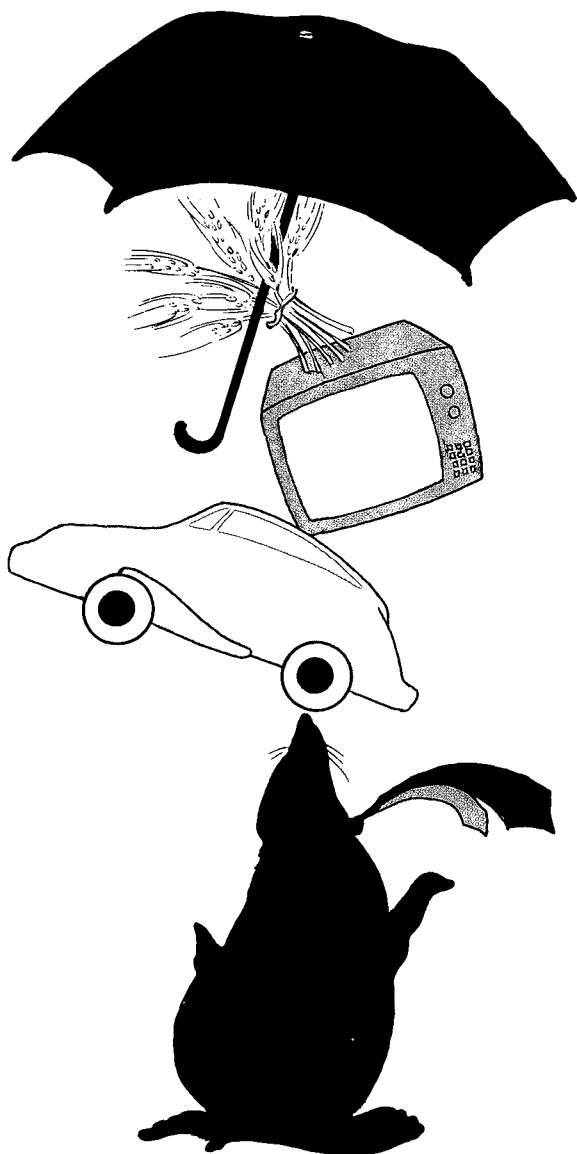
The Changing Concept of Reciprocity

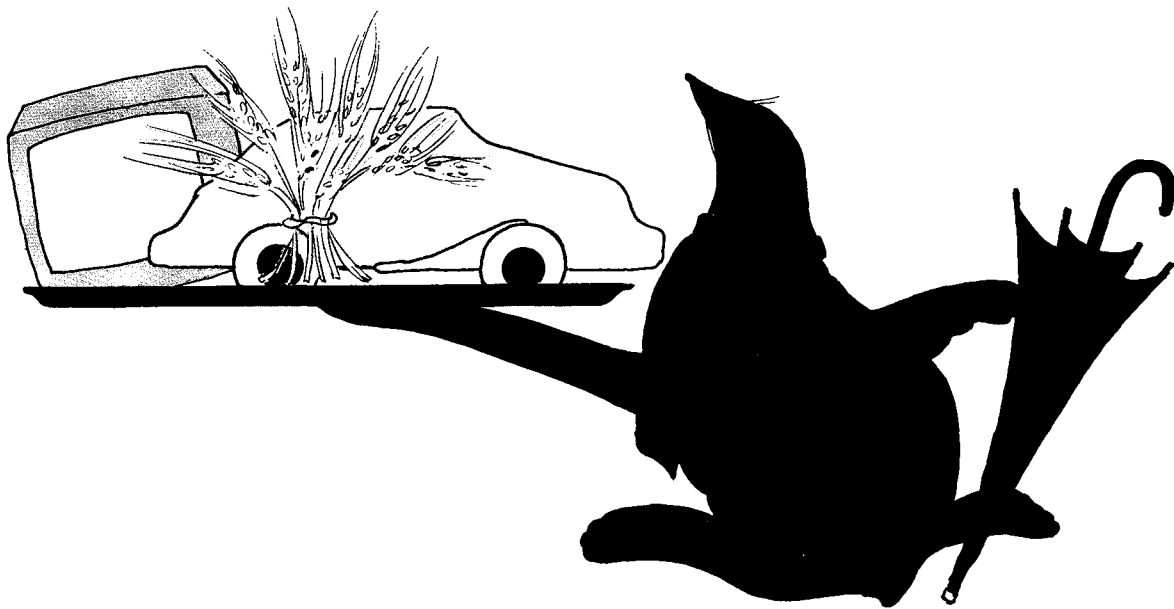
Many politicians and several pundits have responded to the apparently intractable problem of the U.S. trade deficit by advocating a strategy focused on reciprocity as a device to ensure "fairness." If everyone plays the game fairly — that is, according to our rules — on a "level playing field," then positive trade results must inevitably follow.

This logic has two problems. First, there is no reason whatever to think that "fair," or even free, trade will inevitably result in balanced trade for any particular country. A nation's trade balance — or, more accurately its current-account balance — depends on the balance between domestic savings and the domestic uses of those savings, either investment or financing government spending. Trade policy can affect the total amount of trade undertaken, the composition of that trade, and even the directions in which trade is allowed to flow, but it can only affect indirectly and marginally the overall balance, whether surplus or deficit.

The second problem is with the definition of reciprocity. There is nothing wrong with reciprocity as a principle for defining mutual trade commitments among governments. It is the foundation upon which the open world trade system has been so painstakingly reconstructed in the 55 years since the Reciprocal Trade Act of 1934 was passed by the successor congressional generation to Smoot and Hawley.

That principle requires a broadly based exchange of market-opening opportunities, reflecting different countries' assessments of where their comparative advantages lie. In the 1980s, however, the definition of reciprocity has





been increasingly perverted to mean reciprocal treatment by sector, under which two or more nations would be required to align each of their separate commercial regimes and practices on whatever could be negotiated (liberal or not) as a model for that sector. Under this concept, the driving force behind five decades of U.S. trade policy toward greater market openness is replaced by an overriding requirement for "fair" (defined to mean equal) treatment. If that means that we must raise restrictions on others to levels they impose on our exports or investors, so be it, say the advocates of this "fairness doctrine."

Adoption of that doctrine would almost certainly tend to restrict rather than liberalize trade. More than that, it would inevitably push policy toward bilateralism as the governing principle in trade and investment, making "managed trade," rather than market-driven trade, the rule. As trade became increasingly dominated by government officials sworn to enforce negotiated standards of fairness rather than openness, the scope for politicization of trade and investment would widen and the architecture of global strategies upon which the prosperity of the most dynamic American enterprises has relied for growth in the last few decades would collapse. Though many in business and politics argue in favor of the reciprocity and managed-trade strategy, its adoption would be a disaster for all but the least competitive. There is a better way; the next administration should give it urgent attention.

A Multifaceted Strategy for Open Trade

The alternative to the protectionism inherent in each of the managed-trade scenarios is a vigorous, coherent, and sustained market-opening trade policy. It should proceed on four main fronts. They are not mutually exclusive and, properly coordinated and exploited, should be mutually reinforcing.

The first, and in many respects most important, is to *implement a sound domestic economic policy* aimed at restoring balance between a sustainable rate of growth in U.S. investment and the domestically generated savings required to finance it. This objective should be achieved by whatever combination of policies the new administration and Congress agree is appropriate to reduce the net

national dissaving produced by the U.S. budget deficit and to increase the domestic savings rate.

However, this effort should not be undertaken at the expense of yet more counterproductive taxes on competitive American business. Increasing business costs, as the 1986 tax act did to "finance" the cuts in personal income tax, is not the way to promote higher domestic savings, increased efficiency, or enhanced industrial competitiveness. Other methods are available — chiefly by reducing spending to levels that can be sustained by a "pro-competitiveness" tax system. They should be seriously explored in a genuinely cooperative executive-legislative dialogue.

The indispensable complement to a reorientation of U.S. domestic policy must be a reinvigoration of the international economic policy coordination process begun by the Reagan administration. A serious American effort to restore balance to its own economy must be matched by the equivalent efforts of our main trade and economic partners. Japan is the most advanced in implementing such a program, and its movement away from an economy dominated by export-led growth must be sustained over the longer term. The most critical need now is for Europe to regain a sustainable rate of domestic demand-led growth. Europe needs such a reorientation to reduce historically high levels of unemployment and to absorb the rising level of imports of goods and services from whatever source, which must be the counterpart of the reduction in the U.S. external deficit.

Similarly, countries such as Korea and Taiwan, which are running unjustifiable and unsustainable surpluses, must liberalize their domestic markets or face the certainty of increasing political pressure in the United States and elsewhere to close those export markets upon which they have become overly dependent. A coherent administration strategy, implemented through the variety of institutional mechanisms and bilateral negotiations options currently available to move our main partners in these directions, is an urgent necessity.

The remaining elements of the strategy involve the more traditional trade policy tools, though they must be used in imaginative and perhaps less traditional ways. The major elements involve a three-track approach.

Track One

American representatives at the Uruguay Round of trade negotiations in Geneva should vigorously pursue the main negotiating objectives identified over the past two years by the administration and Congress, working in close consultation with American business. Broadly, these objectives involve measures to strengthen GATT rules and discipline; to extend these rules to areas of commercial activity, such as investment and trade in services, not currently covered by GATT; and to liberalize trade beyond the achievements of the last negotiating round, which ended 10 years ago. This track should aim at concluding as many agreements as possible involving all GATT members. However, in the effort to get all members on board, U.S. negotiators should not so compromise our objectives as to impair the value of any agreements reached. Where — but only where — resistance to universally applicable arrangements is too strong, action along the two other tracks, described below, is preferable to stalemate and certainly better than ventures into the reciprocal fairness swamp.

Though multilateral, broad-based agreements should command the highest negotiating priority, the next administration must also realistically assess the probabilities for success. Certain developing countries remain opposed to assuming almost any new obligations in GATT regarding, for example, trade in services, intellectual property protection, and, almost without exception, investment.

But these countries are not the only problem. The European Community (EC) is engaged in a politically difficult internal liberalization process designed to achieve a "single European internal market" by 1992, about the same time that the Uruguay Round is expected to conclude. Even in the best of circumstances, it would be a herculean task to break down the host of internal barriers that restrict free trade in goods and services, that limit the right of any EC national to establish a business in any EC country, and that prevent EC nationals from bidding on contracts for goods and services let by other EC governments and public monopolies. Asking the EC to extend such treatment to others through a series of new GATT agreements may be to seek more than the European political consensus will bear. Most of our negotiating time with the Europeans may well be consumed just in ensuring that American businesses in Europe will be able to trade and operate in that market after 1992 on a fully nondiscriminatory basis.

Whether the EC and others will be disposed to conclude multilateral agreements that broadly meet our main negotiating objectives remains to be seen. While we should not let up on the GATT effort just because the obstacles ahead are formidable, we would be equally foolish to become excessively dependent on the success of the Uruguay Round as our main, much less only, viable alternative to the policy of drifting into protectionism by default, which has become increasingly pronounced during the 1980s. Nor should we be deterred from considering other approaches by a punctilious concern about the fate of the multilateral system. Such concerns ring especially hollow when voiced by the EC, which, virtually since it was created, has been constructing preferential trade agreements of questionable GATT

validity with other Europeans, the countries on the Mediterranean littoral, most of Africa, and parts of Asia and the Caribbean. The unconditional most-favored-national principle, upon which the GATT is anchored and which requires that tariff and certain other advantages accorded to any country shall be accorded to all other GATT members, has been honored at least as much in the breach as in the observance during the last quarter century. There are alternatives to fully multilateral agreements, and they should be explored.

Track Two

This track encompasses negotiations involving only those GATT members prepared to contemplate substantial new liberalization and the significant expansion of international arrangements to cover new areas of commercial relations. The more conventional approach to achieve this result is to negotiate GATT codes addressing specific functions, such as services, involving only some members. This strategy was used in certain areas during the Tokyo Round. Two other less conventional methods should also be explored with potential partners. They are:

- Negotiation of a GATT-consistent free trade area involving as many countries as may be interested and covering most of the points, including tariffs, services, investment, and procurement, that are covered in the U.S.-Canada free trade agreement.

- Negotiation of free trade on a sectoral basis with selected partners. Such an agreement would cover all aspects of commercial relations in the affected sectors, including elimination of tariffs, and would also deal with other rules governing investment, protection of intellectual property rights, government procurement, government assistance to industry, and comparable issues relevant to each sector.

To remain consistent with GATT's most-favored-nation (MFN) requirements, participating countries would have to reduce or eliminate tariffs in the affected sectors for all of their trading partners. However, commitments and concessions exchanged in the other elements of the agreement, such as investment and procurement, could be made on a conditional MFN basis, that is, they need only be extended to other participants in the agreement and not necessarily to all other trading partners.

Ample legislative precedent exists for this approach. The 80-percent-of-trade authority in the 1962 Trade Expansion Act and the high technology section of the Trade and Tariff Act of 1984 both reflect this concept of liberalization by sector. If Congress remains as open to the concept as it has in the past, the new administration should undertake a serious examination of this option as a way to strengthen trade opportunities in areas in which U.S. industry enjoys a comparative advantage. We have had a lot of sectoral protectionism during the last several years. It is time to examine sectoral liberalization as a counterforce and a way to stop a further slide into the restrictive cartelization of international markets.

Track Three

This track emphasizes the purely bilateral approach to removing barriers to U.S. exports. This is the approach embodied in

Section 301 of U.S. trade law, under which the United States negotiates with particular countries for the removal of specific "unfair" trade practices under threat of retaliation if a satisfactory agreement is not reached. However, negotiating pursuant to that process is not the only bilateral option open to the president. Other possibilities include engaging a particular country in a coordinated negotiating process involving all barriers to trade, not just those deemed to be unfair, in one or several sectors, and initiating negotiations among several countries involving a single sector. An example of the former is the Market-Oriented, Sector-Specific (MOSS) process, which the United States initiated with Japan in 1985; the latter is illustrated by the telecommunications talks the United States undertook last year with several European countries.

Though some negotiations under this track should take place on their own merits — pursuant to a well-established case under Section 301, for example — most bilateral efforts should be deployed as part of a comprehensive strategy involving multilateral objectives as well. For example, opportunities to encourage a country to enter into an effective multilateral GATT agreement to protect intellectual property rights could be enhanced by the administration's initiation of Section 301 cases involving violations of such rights. However, use of the retaliatory authority should be sparing and reserved mainly for cases involving a violation of GATT rules. In such limited circumstances, it can be an effective complement to a strategy whose main emphasis must rightly be on multilateral initiatives and strengthening multilateral discipline. Retaliation should certainly not become an indiscriminate weapon whose excessive use undermines its credibility or even threatens the maintenance of an open trade system.

A subset of objectives under this track for the next president must be to complete the unfinished agenda of the U.S.-Canada Free Trade Agreement, assuming its ratification by both countries. As remarkable an achievement as that agreement is, it leaves many issues in U.S.-Canadian trade, investment, and financial relations either untouched or, worse, "grandfathered" with asymmetrical commitments that, left untended, could undermine the public support that the agreement needs to survive. Canadians (and even some Americans) may not want to admit it, but provisions that permit Canadians full exploitation of trade or investment opportunities in the United States while denying Americans equivalent opportunities in Canada (or vice versa) cannot remain unchanged indefinitely without poisoning the whole relationship. These imbalances also demonstrate that even free trade agreements are not immune from the problem of "reciprocity" if they fall short of fully free treatment.

Sectoral Free Trade with Selected Partners

In view of the foregoing observations about the dangers, and therefore the unacceptability, of sectoral reciprocity as the basis for a viable trade policy, why should a sectoral free trade option be explored at all? The answer is simple: some liberalization is better than none and certainly better than the trade-restricting reciprocity option. The challenge is to

*"The challenge is to turn
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Fairness is a potent political concept, and the perceived lack of it can mobilize deep resentment in otherwise trade-indifferent Americans. However, legislating a requirement to match the restrictive practices of others with those of our own in the name of fairness is ludicrous. Restrictions by their nature favor domestic suppliers and are ipso facto "unfair" to foreigners. The only really fair system is one in which no restrictions apply and everyone is treated the same. In other words, free trade, and only free trade, is truly fair trade.

Combating unfairness — whether as demonstrated by specific practices or implied by the existence of a bilateral trade surplus — by forcing other governments to produce measurable "results" only invites more government intervention in markets, more manipulation of markets to favor one over others, and more bilateralism and "managed" trade, to the disadvantage of all. These so-called solutions compound the problem of perceived unfairness and guarantee that the result will really be unfair. Conversely, negotiations to remove barriers to openness, to get government out of the market, to remove obstacles to market efficiency, and to encourage trade and investment are the only sure way to achieve fairness, as well as the prosperity everyone says is the ultimate goal.

If market opening, even if on a less-than-global basis or across only a few traded sectors, is a legitimate objective of trade policy, no one should object if we seek it mainly in markets of future importance to our traders and investors and with partners truly interested in protecting or acquiring equivalent opportunities in our market. Sectoral free trade with selected partners is an option that should be seen as a complement to, not a substitute for, multilateral liberalization of markets by all GATT members. It is also a strategy which recognizes that many GATT countries will be unwilling to make the required commitments, at least in

the initial stages of the exercise, or will have higher priorities elsewhere. Such relative disinterest may be entirely legitimate but should not justify — in the misused name of multilateralism — holding up progress by those who wish to make it.

It is unlikely, and probably undesirable, that GATT-consistent free trade areas can be negotiated among countries that are less interdependent across the full economic spectrum than the United States and Canada, for example, or that are at radically different levels of economic development. The potential for sectoral free trade agreements as a reasonable alternative to all or nothing therefore deserves a serious look. The idea might be developed initially by prospective participants identifying those sectors in which each would like to negotiate fully free access to the markets of the others.

The U.S. list should probably include telecommunications equipment and associated services; pharmaceuticals; medical equipment; electronics, though perhaps not — at least at our initiative — consumer electronics; and certain capital equipment. The existing aircraft agreement could also be renegotiated if deemed desirable. Whole service sectors should be considered as prime candidates. Apart from certain sectors such as textiles and steel that will probably have to be excluded to make it politically realistic for Congress to agree to implement such a strategy, there is no virtue in limiting the list. We should, however, understand that other participants will want to add categories of great interest to them and/or delete some sectors of special interest to us. That, of course, is what much of the negotiation would be about.

We should make it clear that the countries involved are essentially self-selected; anyone who wishes can participate. Realistically, of course, the concept must be sold to others, and our efforts should focus on those whose markets are most important to us and most encumbered by barriers. This suggests a core group including Japan, Mexico, Korea, and various other Asian and Latin American countries. (The assumption is that Canada is taken care of through the U.S.-Canada Free Trade Agreement.) EC participation is problematic, at least in the beginning, but EC members and other European countries should be welcome at any point they choose.

In principle, our objective should be to negotiate liberalization packages for each broad category of products or services. Each package should include the following elements (plus others as the particular circumstances of each sector may require):

1. Elimination or, at least, significant reduction of tariffs and other direct restrictions on imports by all participants, applied on an unconditional MFN basis as required by GATT. However, all of the other elements of the package listed below could be applied only to the other countries participating in the package, provided other international obligations permit.

2. Nondiscriminatory access by each participant's enterprises to bid on contracts let by government or government-controlled entities for the products and services specified.

3. Protection of intellectual property rights concerning covered products and services, enforceable among participants. This provision would not substitute for a broader GATT code but could pick up some countries that for other

reasons might not participate in the main code. A similar point applies in the case of investment, below.

4. Freedom of establishment, exemption from other discriminatory investment requirements, and national treatment (with national security exceptions if necessary) in all participating countries for enterprises producing covered products or offering covered services.

5. Nondiscriminatory access by each participant's enterprises to government-funded research and development programs or other inducements for the development of technological processes or industries offered by other participating governments. This feature is potentially a useful way to undermine the industrial policy practices of governments that discriminate in favor of "national" enterprises. It is also a useful inducement for others to participate in an agreement with the United States because of potential access to large R&D contracts that do not involve security-sensitive technology.

6. Either identification of a list of domestic practices, such as subsidies, that would be neutralized in trade with other partners through export taxes or countervailing duties, or establishment of a process by which parties may take specified offsetting action when injured by another's practices.

7. Establishment of a committee of participants to deal with problems of standards and customs and to add new products or services to the list as may be agreed in the future. This latter provision would make the agreement flexible enough to grow with new technology. The committee would also settle disputes among participants to ensure that an internationally agreed alternative to unilateral national action is available to protect participants from arbitrary action.

Negotiation of a regime along these lines is generally consistent with the mandate in the 1984 Trade Act regarding "high technology products and associated services." It simply defines that sector more broadly and adds some new elements to deal with "fairness" issues. Most important, it stops those countries with no interest in liberalization from vetoing both the initiation and conclusion of a negotiating process in areas of critical importance to our most dynamic enterprises and industries. It permits us to launch a negotiation for major liberalization in those high-growth markets of critical future importance to our exporters when we choose and when enough others agree to make it worthwhile. Finally — and to reemphasize the point — sectoral free trade with selected partners is not an alternative to vigorous prosecution of the current Uruguay Round of GATT negotiations to the most comprehensive conclusion possible. It is a complement, perhaps even a stimulant, to that objective.

Taken together, these four approaches are the components of a comprehensive, trade-expanding strategy that preserves the competitive benefits to American industry and consumers from the continuing or enhanced openness of the American and world markets. It is a viable alternative to the market-closing or competition-numbing prescriptions that have been offered over the last year or so in Congress and on the campaign trail. The opportunity is there for the next president to give both the United States and the world the leadership needed to make open markets and growing economies a reality. He needs to make the most of it.

The Quasi World of the Federal Government

Harold Seidman

SEVERAL YEARS AGO, when I was teaching in Great Britain, I heard frequent references to strange organizations called quagos and quangos. A quago was a quasi-government organization and a quango was a quasi-nongovernment organization. No one was ever able to explain satisfactorily to me how one made the fine distinction between something that was quasi government and something that was quasi nongovernment. We have not been as imaginative as the British in inventing names, but we are now outdoing the British in creating our equivalent of quagos and quangos and blurring the traditional definitions of government and private. Developments in the last 20 years might make one suspect that the U.S. government is going quasi.

At one time there was no question that an agency created by Congress for a public purpose, directed and controlled by federal officers, and funded directly or indirectly by the Treasury was a government agency. Some 40 years ago the Supreme Court held in the case of *Cherry Cotton Mills vs. U.S.* (1945) that the designation of the Reconstruction Finance Corporation as a corporation did not "alter its characteristics so as to make it something other than what it actually is, an agency selected by the government to accomplish purely governmental purposes." Today one can no longer determine whether an agency is government or nongovernment by applying these simple tests. Confusion is compounded by the media, the General Accounting Office, and even by some of my learned colleagues who often refer to government agencies and corporations such as the Post Office and Tennessee Valley Authority as "semi-private" or "federal-private" because they are financed in the main by user charges. The only way to determine an agency's legal status is to read the fine print in the law. But congressional intent is by no means always clear, and the language may be deliberately designed to obfuscate the issue.

When it established the late and unlamented Synthetic Fuels Corporation, Congress apparently could not make up its mind whether it was creating a government agency, a nongovernment agency, or something else. The law in one place defines the corporation as "an independent federal entity" and in another states that it is "not an agency and instrumentality of the United States." No other law applied to the corporation "as if it were a federal agency," except when the establishing law provided that it should be treated as a federal agency. The liability of the corporation was limited to its assets, except that all of its contracts providing for financial assistance were to be general obligations of the United States backed by its full faith and credit. In its attempt to compromise fundamental differences about the corporation's government and nongovernment status, Congress produced a hybrid that defied rational classification.

Some experts in public administration consider the blurring of the

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traditional dividing lines between what is government and what is private to be a desirable reflection of the real world. Bruce L. R. Smith believes that distinctions between the public and private sectors have "ceased to be an operational way of understanding reality." According to Graham Finney, the blurring reflects the "increasingly pluralistic character of this complex society" and the fact that "an either/or, public/private world, separating government and for-profit enterprises, has long ceased to exist, if it ever really did." In a recent book, *All Organizations Are Public*, Barry Bozeman argues that "sector blurring" is not only present and inevitable but the desired way to plan for the future.

Ronald C. Moe and Harold J. Sullivan challenge these views in the November/December 1987 *Public Administration Review*. Moe and Sullivan recognize that private individuals and agencies are not subject to the same body of laws as federal agencies, their officers, and employees. Such laws and regulations are designed to prevent abuse of power and to assure fairness and openness in the administration of laws; honesty, integrity, and competence of public officers and employees; and accountability to duly elected officials and the public. Profound constitutional questions are raised by the vesting of government functions and authorities in quasi-government institutions that operate outside the established legal system. The maintenance of a distinction between government and nongovernment has been considered essential both to protect private rights from government's intrusion and to prevent private usurpation of government power. Are these quasi institutions merely an accommodation to current realities? Or do they represent a potential threat to responsible and accountable democratic government?

As Charles Levine points out, two great disasters of the Reagan years, the Challenger tragedy and the "Irangate" scandal, dramatize the consequences of intermingling government, nongovernment, and quasi-government agencies in the decisionmaking process. "... clear lines of accountability disappeared and distinctions between private action and public responsibility became meaningless to the participants," Levine concludes about both incidents. "When the political dust had settled no one was sure who was to blame."

It is significant that the chapter of the report of the congressional committees investigating the Iran-contra affair dealing with the quasi-private covert agency known as "the Enterprise" is entitled "Rule of Law." Congress professed to be shocked by the creation of the "off-the-shelf" company to conduct government operations outside the law and the constitutional process. Yet in resorting to extraconstitutional measures to evade irksome laws and regulations, CIA Director William Casey was adopting for his own purposes the model Congress itself had devised.

Oliver North told the committees that Casey wanted an agency that was "self-financing, independent of appropriated monies." This was precisely Congress' objective when it converted the Federal National Mortgage Association from a mixed-ownership government corporation to a government-sponsored private enterprise. It is by no means a coincidence that Fannie Mae was created in 1968 following adoption of the unified budget, which for the first time included trust funds and expenditures for Fannie

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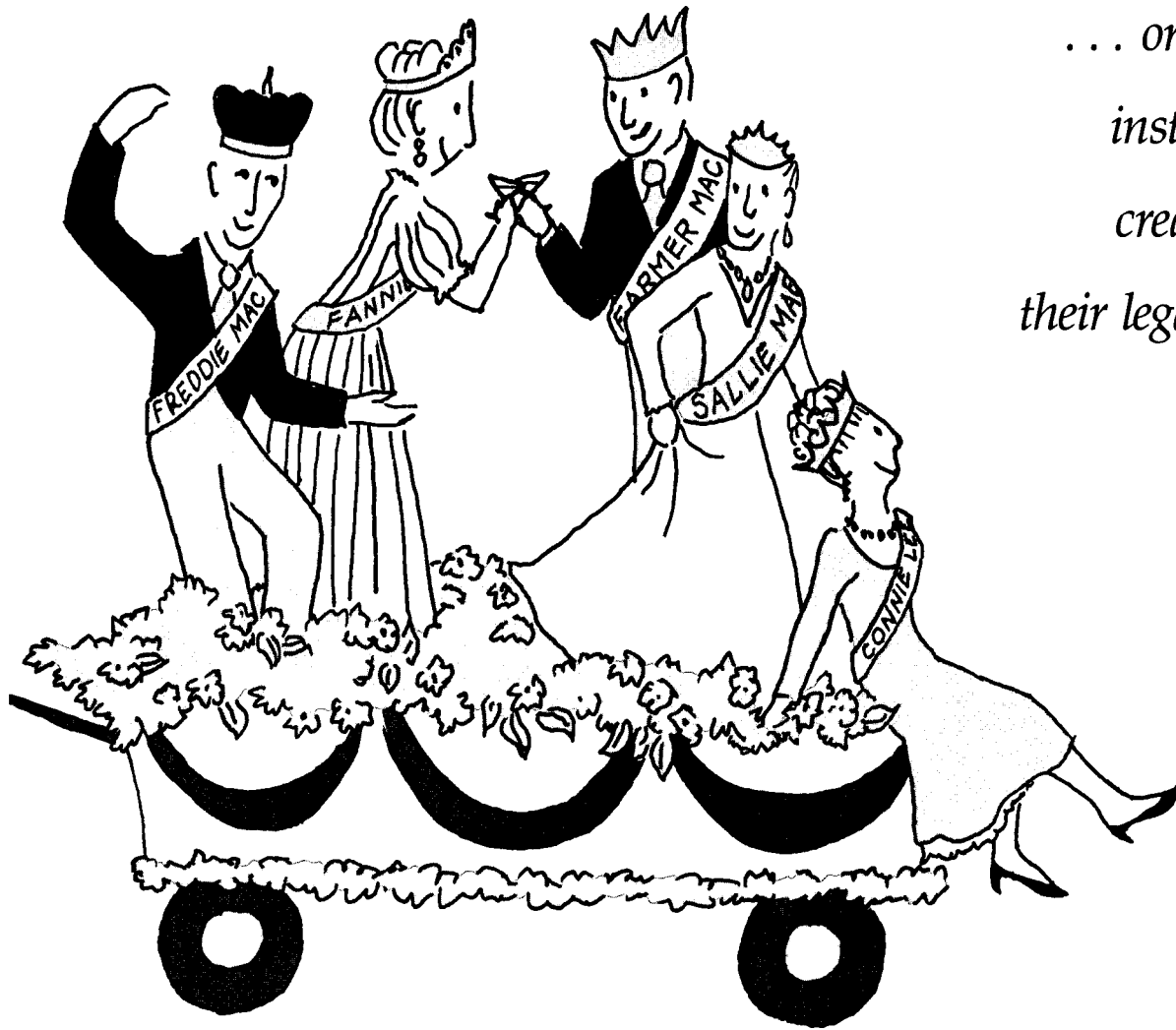


Mae's secondary market operations. Housing and Urban Development Secretary Robert C. Weaver said the agency's conversion was necessary to avoid "the vagaries of the budget situation" and to put the secondary market operations "outside the budget." Since 1968 the Congressional Budget Act, the Gramm-Rudman-Hollings Act, and other restrictive budgetary measures as well as unrealistic pay caps and personnel ceilings have increased pressure to find ways and means to finance programs "off-budget."

Several organizations have been established in Fannie Mae's image, including Freddie Mac (Federal Home Loan Mortgage Corporation), Sallie Mae (Student Loan Marketing Association), Connie Lee (College Construction Loan Insurance Association), FADA (Federal Asset Disposition Association), and Farmer Mac (Federal Agricultural Mortgage Corporation). This list does not include other government-sponsored enterprises or private nonprofits such as the Securities Investor Protection Corporation, Corporation for Public Broadcasting, Legal Services Corporation, Community Development Corporation, Neighborhood Reinvestment Corporation, Farm Credit System Insurance Corporation, and Farm Credit System Assistance Board, to name but a few.

Government-sponsored enterprises are not a single class of institutions with common purposes, operating needs,

... or quasi-private
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and financial requirements. All that they share is non-government status and exemption from most, but not all, laws and regulations applicable to federal agencies, officers, and employees. This exemption does not mean, however, that government-sponsored enterprises are subject to the laws and regulations applicable to comparable organizations in the private sector — many are expressly exempted from those laws and regulations. While called "private," these enterprises really function in a *terra incognita*, somewhere between the public and private sectors. What we are witnessing is not privatization, but degovernmentalization.

Private status has not been equated with equity investment by private individuals or companies. Corporations such as the Securities Investor Protection Corporation, Legal Services Corporation, and Corporation for Public Broadcasting have no stockholders and are owned by the United States government. Others such as Freddie Mac and FADA have as their principal stockholders the Treasury or other government and quasi-government institutions. The exceptions are the "for-profit" enterprises — Fannie Mae, Sallie Mae, Connie Lee, and Farmer Mac — whose charters provide for public sale of common stock. Based on asset size, Fannie Mae and Sallie Mae rank among the nation's 100 largest and most profitable

publicly owned corporations, and their shares are traded on the New York Stock Exchange.

Private status also has not been reserved for government-created corporations that produce revenue and are potentially self-sustaining. Several, including the Legal Services Corporation and Corporation for Public Broadcasting, are financed by annual appropriations, grants, gifts, and reimbursements.

Private status has not been construed as requiring nongovernment participation in direction and management. Provision for appointment of directors by others than the president or designated federal officers is limited to Fannie Mae, Sallie Mae, Connie Lee, Amtrak, Farmer Mac, FADA, and National Housing Partnerships. The majority of the quasi-private agencies are controlled by directors appointed by the president or federal agency heads, or by boards composed of federal officers serving *ex officio*. For example, the Federal Home Loan Bank Board is the board of directors of Freddie Mac.

These maverick organizations are able to exploit the ambiguity of their legal status to eliminate or reduce accountability to the government, their shareholders when they have them, and the public. The rights of private shareholders are not those of investors in private companies and are limited with respect to election and

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removal of directors, inspection of corporate books, and other matters.

Indeed government-sponsored enterprises can select whatever legal status best suits their purposes. When HUD Secretary Patricia Harris directed FNMA to increase its percentage of mortgage purchases in central-city areas, the agency insisted it was private. It argued that its primary obligation was to its stockholders who would be disturbed if it invested in less profitable and more risky projects. FNMA argued no less vigorously that it was a federal instrumentality when New York State attempted to compel it to pay interest on its escrow funds. In objecting to Reagan administration proposals to cut off its special privileges — its line of credit with the Treasury, tax exemptions, eligibility of obligations for purchase by federal trust funds, exemption from Securities and Exchange Commission regulations — FNMA protested that "Congress established Fannie Mae to run efficiently as an agency, not as a fully private company." Without these special ties to the government, Fannie Mae says it would be forced out of business.

The current problems of FADA illustrate the potential conflicts of interest and breach of public trust that may result from the failure to maintain a distinction between what is government and what is private. The Federal Home Loan Bank Board chartered FADA as a private, wholly owned subsidiary of FSLIC with a \$50 million guaranteed line of credit with the Federal Home Loan Bank of Topeka. Free from the budgetary constraints and personnel regulations applicable to the FSLIC, FADA as a "captive organization" was designed to draw the best talent in the private sector to manage and liquidate FSLIC-acquired assets at the best possible prices.

From the very beginning FADA was mired in controversy. It hired a president and chief executive at \$250,000 a year and paid her a \$75,000 bonus after nine months. Several FADA board members and executives had long-established business relationships with failed institutions or with companies bidding to buy and manage their assets. A report to the House Banking Committee published in the April 21, 1988, *Congressional Record* catalogs numerous instances of alleged conflicts of interest and open disregard for government regulations and direction by FADA's owner, the FSLIC. A committee majority has called for FADA's abolition.

The federal government remains responsible for the quasi-government or quasi-private institutions it has created, whatever their legal designation. Although the obligations of most government-sponsored enterprises are not guaranteed by the government or backed by the full faith and credit of the United States, they are regarded, nonetheless, as government obligations by the financial community and are assumed to have the implicit support of the United States government. It is believed that, if necessary, the government would bail out these institutions as it has done for the farm credit banks. Yet at present neither the president nor Congress is able to exercise effective control over the massive and escalating contingent government liability these enterprises are generating (see table 1).

Government-appointed or -designated directors tend to reinforce the public perception that the government stands behind these enterprises. But such appointments

do not provide essential public accountability and control. Indeed, in 1962 Attorney General Robert Kennedy held that presidentially appointed directors of a private corporation were not officers of the United States, as defined in the Constitution, and owed a fiduciary obligation to the corporation and not to the government.

In making such appointments the president clearly is performing an extraconstitutional act. Furthermore, if government-appointed directors are not federal officers, then serious questions may be raised about the propriety of the secretaries of Treasury, Agriculture, Transportation, and Interior and members of the Federal Home Loan Bank Board serving as directors of private corporations. Ordinarily, federal officers are barred from holding positions that involve a potential for conflicts of interest. To whom are they accountable for their actions as directors — Congress, the president, or the corporation?

Functioning outside the established legal system, these quasi-private enterprises may be more, not less, vulnerable to partisan political influences. The Hatch Act and civil service laws do not apply to their officers and employees. Each president has utilized his authority to appoint directors to reward political supporters. The Corporation for Public Broadcasting and the Legal Services Corporation have been at times the center of partisan political controversies. In 1986 FNMA established a political action committee to funnel donations to members of Congress, particularly those on its oversight committees; no government agency may legally make campaign contributions.

The vesting of public functions in extraconstitutional institutions, most of which are private in name only, undermines the president's constitutional powers and constitutes a threat to orderly and responsible democratic government. The president's executive power has never been construed to include appointment of nonfederal officers or direction of nongovernment institutions. If Congress by legislative fiat can label institutions for which the government remains responsible and accountable as "private," it is able to negate the president's ability to exercise his constitutional powers and to take care that the laws are faithfully executed.

We will not solve the fundamental problems that now frustrate federal administrators by going outside the system and relying more and more not only on government-sponsored private enterprises, but also on "captive corporations," such as federally supported research corporations. These organizations operate under contracts between executive agencies and private contractors to advise on public policies and to manage and operate government programs. The government is being reduced to the role of paymaster, contract administrator, and auditor. At the very time the president and Congress argue that they must go outside the government to get things done, they are subjecting government managers to a rapidly growing burden of complex and often irrational controls and regulations that makes it difficult for them to function.

The National Academy of Public Administration in its report, "Revitalizing Federal Management," concluded: "federal managers are captives to a series of internal management systems which they do not control. These systems have tended to become so rigid, stultifying, and

Table 1. Lending and Borrowing by Government-Sponsored Enterprises
(in billions of dollars)

	Actual 1987	Estimated 1988	Estimated 1989
Total Net Lending			
Obligations	\$427,518	\$425,093	\$462,161
New transactions	414,092	420,571	453,983
Net change	107,785	92,277	88,355
Outstandings	581,073	673,352	761,706
Total Borrowing			
Net change	115,046	96,681	91,994
Outstandings	569,212	665,893	757,887

Source: The Office of Management and Budget.

burdened with red tape that . . . managers' capacity to serve the public on a responsive and low cost basis is seriously undermined." The Reagan administration has acknowledged that current management systems "are becoming obsolete and falling into disrepair faster than we know how to fix them [and] should be given urgent attention." Unfortunately, administrative reform is judged by our elected public officials to have minimal political appeal. If necessary steps to deregulate the government are not taken and present trends are not reversed, we are likely to end up with two governments: one subject to the rule of law and the Constitution, and the other an outlaw government composed of quasi-government and quasi-private institutions that can utilize public authorities and funds for their own purposes.

Government-sponsored private enterprises provide few, if any, of the benefits that the Reagan administration claims will be achieved by privatization. The purposes these quasi organizations were meant to serve can be better achieved without blurring the dividing line between what is government and private. Public agencies do not have to be called private to escape restrictive statutes that limit funding, impose arbitrary personnel and pay ceilings, and otherwise hamper operations. It is possible to design federal agencies with the financial and operating flexibility necessary to enable them to carry out their assigned mission; that was done in the past with government corporations. President Franklin D. Roosevelt described the Tennessee Valley Authority as "a corporation clothed with the power of government but possessed of the flexibility and initiative of private enterprise."

When appropriate, the government may also provide financial and other assistance to private organizations through loans, grants, and subsidies. Regulations and contractual agreements can be written to protect the public interest without involving the government or federal officers in the ownership or management of a private enterprise. If we persist in ignoring the distinctions between what is government and what is private, we do so at our peril.

The Continuing Resolution: A Crazy Way to Govern?

Joe White

ON JANUARY 25, 1988, President Reagan stood before Congress and reported on the State of the Union. This Congress and this president are rather tired of each other, and his speech was tepidly received. Yet almost everyone cheered when Reagan complained about the continuing resolution, a device Congress used to wrap all of the 13 regular appropriations bills into a single package at the very end of the 1987 session.

"Last year," the president declared, "of the 13 appropriations bills due by October 1, none of them made it. Instead, we had four continuing resolutions. . . . And then," pausing to reveal three huge stacks of paper, "along came these behemoths. This is the conference report — a 1,053-page report weighing 14 pounds. And this," plopping another foot of legal-length paper down on the table at his side, "a reconciliation bill, six months late, that was 1,186 pages long, weighing 15 pounds. And the long-term continuing resolution, this one was two months late, and it's 1,057 pages long, weighing 14 pounds. . . . Now that was a total of 43 pounds of paper and ink. You had three hours, yes, three hours, to consider each, and it took 300 people at my Office of Management and Budget just to read the bill so the government wouldn't shut down."

"Congress shouldn't send another one of these. No. And if you do, I will not sign it."

It was good theatre: funny and simple enough for anyone to follow. The point seemed incontrovertible: nobody could understand such huge piles of paper in so little time; obviously that was a bad way to do business. The legislators, judging from their laughter and applause, seemed to agree.

Television viewers could hardly have realized that the president was really complaining about only one bill, the continuing appropriations resolution, and was using the others to add to the effect. Nor could viewers have known that the president concurred in Congress' decision to combine all appropriations into a single omnibus bill in order to implement the deficit reductions that Congress and the president had negotiated in the highly publicized "budget summit" after the October 1987 stock market crash.

Which raises two questions: why was the president complaining, and why was Congress applauding?

Two days later, in a letter to Speaker Jim Wright, 49 House Democrats protested that omnibus continuing resolutions resulted in "the effective disenfranchisement of many Members of Congress from the legislative process, and the failure by the Congress itself to give careful and adequate consideration to many critical issues. . . . We believe that, in many cases, these issues would result in very different outcomes through greater involvement of the House membership if they were considered through the normal legislative process rather than collectively in a continuing resolution." Therefore, they announced their

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"intention no longer to support the use of the continuing resolution as an end-of-session, fiscal year catch-all legislative vehicle. To do so is destructive of the jurisdictions of the authorization committees and prevents the orderly consideration of individual appropriations bills."

The letter suggests three objections to the CR, as it is familiarly called: that it is bad procedure in principle, that the procedure affects substance in an unacceptable manner, and that it changes the balance of power among members of Congress, favoring members of the Appropriations committees. Of these objections, the latter is most clearly accurate. Yet there are only 29 members of Senate Appropriations, and 57 members of the House committee, and they cannot impose such a procedure on their chambers. The CR, so widely scorned, must do something for someone else. It does; one can argue that the CR is not the problem but the solution to a problem; namely, how to pass the bills that fund government activities in a time of divided political authority and great budget constraint.

Spending and the Power of Congress

Before we condemn continuing resolutions as undemocratic or unwise, we must first understand what they were intended to do and how that function has changed during the 1980s.

The controversy over the continuing resolution is, in the first instance, another case of the historic tensions between the president and Congress. The Constitution states that "no money shall be withdrawn from the treasury but in consequence of appropriations made by law." This provision was intended to ensure Congress the "power of the purse," which James Madison in number 58 of *The Federalist* called "the most complete and effectual weapon with which any constitution can arm the immediate representatives of the people."

By appropriating "for the service of the present year" a grand total of \$639,000, divided into four categories, the first Congress established a pattern of annual appropriations that has prevailed ever since. Annual appropriations give Congress a powerful check on executive branch activities, but they also have a critical weak point: if appropriations are not passed, the agencies in question have no money and cannot function. Since spending bills, like other legislation, require agreement by a Senate, House, and White House that may be disposed to disagree, failure is hardly out of the question.¹

Spending and Power Within Congress

While annual appropriations maintain Congress' power vis-à-vis the president, organizing itself to make those appropriations creates a tension over power within Congress. To review the mass of detail submitted by agencies to justify expenditures, and to lessen the possibility that its legislative committees would have too great an interest in program expansion and not enough in fiscal control, both houses created separate appropriations committees. Ever since the House committee was created in 1867, members of the authorizing committees have accused it of trampling on their turf.

The accusations arise because, as one legislator said, "Nothing happens until you spend the money." Thus,

funding decisions can be used to make policy that is ostensibly in other committees' jurisdictions. Members of Congress strive to maintain a boundary between the proper spheres of authorizations and appropriations. As two subcommittee chairmen on House Appropriations put it, authorizing legislation defines national "need," while appropriations decisions should be more technical — "the most efficient way to spend money" or "what we can afford at the time, what programs are working." House rules provide points of order against legislating in an appropriations bill, against funding activities that have not been authorized, and against appropriating more than the authorized limit. These norms and rules limit, but cannot eliminate, conflict. Members thwarted in the authorizing process will always be tempted to try to get their way by cutting off funds in the appropriations, as did opponents of both the Vietnam War and abortion in the 1970s. Appropriations committees in deciding what projects have priority are choosing among ends even if they base their decisions on the suitability of means.

When Appropriations provided the only annual review of agency activities, members of other committees felt at a further disadvantage: administrators of agencies naturally paid more attention to the Appropriations members, whom they had to satisfy every year. From the late 1950s on, the authorizing committees responded by moving to short-term authorizations of many federal programs. Frequent reauthorizations gave less excuse for policymaking on appropriations bills; yet the Appropriations committees retained substantial power because they controlled spending.

Unfortunately, short-term authorizations can produce a dilemma: Congress and the president, or forces within Congress, can get hung up in a dispute over the details of the reauthorization of some program or agency that everyone knows will be continued, such as the Department of Justice. Then the choice is between not making the appropriation or breaking the internal rules.

Enter the CR

The continuing resolution is a device to keep agencies and programs afloat if they do not have permanent appropriations and the annual ones have lapsed. In 1982 a General Accounting Office report summarized the understanding that had prevailed to that time: "Continuing resolutions are temporary appropriation acts . . . intended by Congress to be stopgap measures enacted to keep existing Federal programs functioning after the expiration of previous budget authority and until regular appropriation acts can be enacted. The Congress resorts to the continuing resolution . . . perhaps because the two Houses have not yet agreed on common language, because authorizing legislation has not been enacted, or because the President has vetoed an appropriation act passed by Congress."

The rules forbidding authorizations on appropriations bills do not apply to continuing resolutions, a fact that allows Congress to overcome the lapsed authorization problem. That CRs were initially intended as stopgap measures was evident in their wording. Rather than providing exact amounts of money, the language usually appropriated "such sums as may be necessary" to continue activities at a "rate for operations" defined by some other

*“... one can argue that the CR is not the problem
but the solution to a problem; namely,
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authority and great budget restraint.”*

document, commonly the spending bill for the preceding year or the lower of the rates contained in the current House- or Senate-passed bill or in some other set of alternatives. These formulae could get pretty complicated; one staffer calls their drafting a “black art.” Yet because these CRs were seen as temporary, they were not so controversial. The spending levels were high enough to let agencies function but not so high that they removed the incentive for Congress and the president to agree on regular authorization and appropriations bills.

Congress used this limited version of a CR frequently; from 1961 to 1980, 85 percent of the regular spending bills were enacted late, requiring temporary appropriations. Occasionally a bill would be stalemated and funding for the entire year managed through a CR. Thus the regular appropriations bill for the departments of Labor and Health, Education and Welfare was hung up by conflict between Congress and President Nixon in 1972, and over federal funding for abortions in 1977, 1979, and 1980. Such standoffs, however, were not the norm.

The CR Transformed

By 1987 the continuing resolution looked very different. It weighed 14 pounds because it included the texts of 13 separate appropriations bills, not formulae. (The weight was also a matter of fancy paper with large print; the bill ran 132 pages in the *Congressional Record*.) Each section had been negotiated by the members of the Appropriations subcommittee concerned, just as if it were an individual bill.

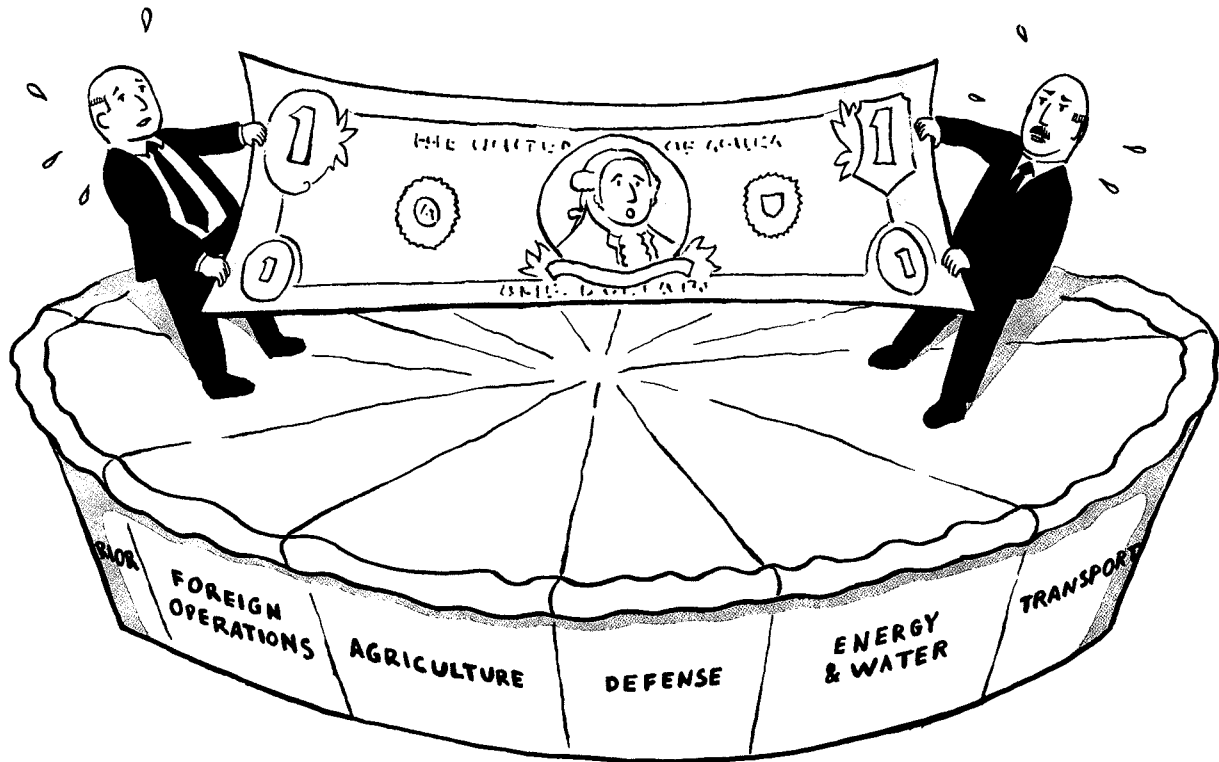
As Rep. Neal Smith, D-Iowa, informed critics, with some asperity, the CR now looked much like what once had been considered “the ultimate reform” — an omnibus appropriations bill, “like the state legislatures do.” The CR did what the Budget Act of 1974 promised but did not

deliver: forced consideration of budget details in the light of budget totals — and vice versa. Congress was voting on both at once.

Yet the CR was not treated as reform. It was accused of increasing spending and carrying “pork,” limiting debate, trampling on the authorizing committees, and distorting the balance of power between Congress and the president. It also was not developed and justified as a reform would be. Rather, the CR evolved from a stopgap to an omnibus appropriation in a series of incremental reactions to stalemate over federal spending and deficit reduction.

The evolution toward the omnibus CR began in 1980, when post-election posturing on the deficit forced Congress to package five regular appropriations bills in a CR that kept spending down by expiring four months before the end of the fiscal year (the CR was routinely extended through the end of the fiscal year a few months later). In 1981 the Republican Senate — at the president’s request — delayed all spending bills past October 1, the beginning of the fiscal year, while the administration developed new spending reduction proposals. After both Republicans and Democrats rejected those proposals, a search began for a formula to balance defense and domestic spending cuts in a way that all sides could accept. Efforts to negotiate the formula in a CR broke down when Reagan vetoed it, but the pattern for an omnibus spending bill had been set.

Broader budget warfare also prevented timely action on appropriations in 1982. Consequently, leaders of both houses wanted to wrap up the appropriations in a continuing resolution before the election so they would not have to return for a lame-duck session. Reagan, hoping for a better deal later, insisted on a post-election session. In the end six bills were packaged in a CR signed December 21. In a harbinger of things to come, the precise



texts of the Defense and Labor-HHS-Education bills were included in the CR. The trend toward omnibus CRs slowed in 1983 because the House Appropriations Committee convinced the leadership to let it move much faster and because the administration was much more willing to work with Republicans on the House and Senate committees to find agreement. Only three bills were not passed separately. In 1984, however, budget strife and the trend toward big CRs intensified. Eight regular spending bills were packaged in a CR, either by reference to a separate conference report or by incorporating the text.

Then came the Gramm-Rudman-Hollings deficit reduction act, designed to force Congress to cut the budget deficit to predetermined levels. In 1985 the disagreements that provoked Gramm-Rudman and slowed negotiations on that measure also delayed action on appropriations. Then, after Congress passed Gramm-Rudman, it discovered the deficit reduction measure made passage of individual spending bills nearly impossible.

Gramm-Rudman set up a "sequester" process, which provided for across-the-board cuts in most of the annually appropriated accounts if the regular spending bills passed by Congress did not reduce the deficit to the preset level. The language of Gramm-Rudman requires separate appropriations bills. The politics requires an omnibus bill. So long as there is any chance of a sequester at the end of the process, few legislators are prepared to give final approval to individual spending bills. Everyone might agree on a spending level for one bill, only to find it reduced by the sequester process because other spending bills did not meet the overall target. In July 1986 the Supreme Court ruled that the original sequester process was unconstitutional. But the presence of a backup process in the act, and strong pressures to create a new sequester, meant that passing separate bills was still risky. In 1987 Congress put in place a new sequester procedure as part of a second

Gramm-Rudman deficit act. In both years, all appropriations were packaged in an end-of-session continuing resolution.

The logic of Gramm-Rudman reappeared on a broader scale when Congress and the president negotiated deficit reductions for 1987 and 1988 after the October stock market crash. All appropriations, all tax hikes, and all entitlement reductions had to be produced together — taxes and entitlements in a reconciliation bill and appropriations in a CR — so that all parties could see the deal had been kept. Rep. S. William Green, R-N.Y., expressed the logic neatly in the debate on the rule for the CR: "The Appropriations Subcommittee for HUD and Independent Agencies, on which I am ranking Republican, is involved in a lot of endeavors. None of us wanted to give up what we were interested in among the endeavors unless we saw that everyone else was doing the same. . . . All of us wanted to see that what we were fighting for and what we had to give up at the end was not going to be the only thing that was given up but that others suffer equally."

Once Congress and the president produced Gramm-Rudman, they had no right to object to omnibus continuing resolutions. That is like someone who jumps off a building complaining about falling. Nonetheless, they complained.

Reagan's Objections

Ignoring his own role in making continuing resolutions necessary, President Reagan condemned the 1987 procedure on the grounds that it increased wasteful spending and deprived him of his constitutional role in making spending decisions. In his State of the Union speech, Reagan charged that the CR allowed Congress to hide away all sorts of "pork." His evidence was weak. The president cited agricultural research grants, but Congress has always funded those in the regular appropriations. His cranberry

and blueberry examples had even been mentioned on the House floor. A later list of items Reagan said he would have vetoed included a guarantee of staffing levels for the Customs Service — an issue on which Congress has repeatedly rejected Reagan's proposed personnel cuts. Even the most publicized "goodie," aid for North African Jews in Paris (since rescinded), could as easily have been in a separate spending bill; its sponsor, Daniel Inouye, D-Hawaii, is the chairman of the subcommittee with jurisdiction over such matters. One can argue that these items are or are not pork; it is more difficult to argue convincingly that their number increased because of the CR.

Reagan also has said that the CR reduces his presidential discretion, forcing him either to accept the whole package or shut down the whole government. Some senior Democrats agree; the CR is "a terrible thing to do to a president," one said. Yet 1987 alone suggests that argument is overstated. Reagan used his veto threat to win aid for the contras in Nicaragua and to remove provisions in the CR that restored the "fairness doctrine," which the Federal Communications Commission had earlier abandoned. To prevent a veto, the Appropriations committees gave far more information to OMB than they had in previous years. Obviously, Reagan's threat retained some credibility.

On the record it is hard to argue that Ronald Reagan worries more than the average legislator about shutting down the government. He vetoed a CR in 1981 and kept threatening to in other years. As for closing down the government, he appeared to make that decision based on his own convenience. When a CR lapsed in 1983, the president, off on a trip to Asia, let the government run. In 1984, in the same legal circumstances, he ordered a shutdown and blamed the Democrats — just before his first debate with election opponent Walter Mondale.

The CR is not veto-proof, and the threat to shut down the government is as much a weapon for the president as against him. A more telling argument emphasizes that the CR tilts the political dynamic between the two branches toward Congress by packaging appropriations the president wants — in Reagan's case defense and foreign aid —

with spending he doesn't want. As one Democrat put it, "When there is a difference on priorities, the legislative branch will hold back the two bills that are the only ones he wants. They are leverage to keep the administration from savaging your priorities and getting its own."

Everybody agrees that the CR has been used to this effect. In principle, however, there is nothing wrong with Congress, rather than the president, winning a battle over priorities. Furthermore, the CR allows Congress to show that increases above the president's budget on social programs do not raise the deficit, for compensating reductions in defense are in the same bill. This may be frustrating for the president because it deprives him of the argument that Congress' domestic spending "busts the budget." But the CR can hardly be considered bad procedure because it demonstrates that a charge is false.

The CR has been a weapon in the fight between the parties over priorities, and in the conditions of the mid-1980s it has, on average, favored the Democrats in Congress.² Also, by bringing a lot of legislative issues to the table at once, Congress creates the dynamic for some give and take. If Reagan wins some, Congress will win others. These effects do not justify the president's claim that the CR subverts the constitutional balance between the executive and legislative branches. Whether the marginal advantages to Congress seem good or bad ought to depend on which side one agrees with substantively.

Congressional Objections

Yet during debate legislators of all political stripes complained about the process. Repeatedly members said they were being railroaded into decisions without enough time to debate them. That objection was not entirely true. All 13 regular spending bills had gone through the normal legislative routine of committee hearings, markups, and committee reports. Ten of them had been debated and passed on the House and Senate floors.

It is true that three bills, Defense, Foreign Operations, and Agriculture, representing over half of the spending,

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were never debated separately. The contents of those bills were no secret; the basic drafts had all been available for at least a month before they came to the House floor in the CR. But the rule for considering the CR in the House allowed only seven amendments, none on the figures in those three bills. House members who objected to the spending levels had to defeat either the rule or the bill. They failed to do either, but lack of time for debate does not explain their defeat. They simply did not have the votes, just as they did not have the votes on many of the amendments they offered to the 10 spending bills considered separately earlier in the year.

Members who said that the CR contained too much authorizing language have a more legitimate objection. Explicit authorizations included an amendment to the Federal Aviation Act prohibiting smoking on domestic flights of two hours or less and a measure to facilitate Amerasian immigration. Implicit authorizations included funding for most of the programs operated by the Commerce, Justice, and State departments, which had not yet been reauthorized. If the CR had not reauthorized these programs, individual appropriations likely would have done so. Why some members blamed the CR for Congress' failure to pass the regular reauthorizations is therefore less than obvious.

Those explicit authorizations that survived conference tended to be relatively noncontroversial because the managers of the CR could not risk final passage of the bill by adding contentious amendments. Conferees, for example, eliminated a potentially explosive provision to expand the amnesty for illegal aliens. It is difficult to argue that the authorizations added to the CR were necessarily bad or even dramatic policymaking.

But if the rest of us have no grounds for objections, legislators have good reason: in the conference, Appropriations Committee members, not authorizing committee

members, were negotiating what items would stay and which would go. For example, Rep. Romano L. Mazzoli, D-Ky., the House sponsor of the amnesty law, objected to the proposed expansion but had no forum to voice his opposition. Rep. Edward Roybal, D-Calif., a member of the Appropriations Committee, added the provision to the CR. The rule for floor debate did not permit a separate vote on the issue, and so the provision went to conference. Roybal lost in the conference, but Mazzoli had to rely on friends in the Senate to make his case. Because Mazzoli did not sit on Appropriations, the process made him more of a lobbyist and less of a lawmaker.

I have interviewed over half of the members of House Appropriations off the record. Most will admit that the process in the short run benefits Appropriations members. One Democrat commented that it was "exhilarating" to be able to shortcircuit the usual complex process and accomplish something. A Republican in the middle of condemning the CR paused and then said: "You can bury some ponies in a pile that big; I've done a little myself. . . . It has a seductive appeal. When [committee elders] make speeches on the floor when the CR comes up, all about how terrible it is, what an abuse of the process—I think to myself, 'It hurts so good!'"

These members are equally convinced, however, that the CR is not good for either Congress or their committee. "They are the worst way in the world to appropriate." "It's horrible . . . ludicrous." "A terrible process, not normal." "By far the process as intended is better."

Appropriations members make all the arguments that others have made, and more, about why they are not to blame for the CR. They blame delays caused by the budget process. House members blame the Senate, emphasizing that much of the legislating on appropriations is initiated in the "other body." Some assert that the president will never sign certain bills, so Congress is forced to package

them with spending bills he will sign. In sum, as one put it, "It's the only vehicle we have. . . . I think that even people on the authorizing committees are glad there's a vehicle they can hang their hat on."

The burden of their case, and it has some merit, is that the Appropriations committees did not set out to grab power. Their influence has increased, as one senior member put it, "not by design but by dumb accident." Yet their sensitivity shows how important jurisdictional issues are to legislators. This is particularly true in the House, where proportionately fewer members serve on Appropriations than in the Senate; where members who sit on Appropriations are barred from sitting on any authorizing committee, which makes the boundaries between authorizing and appropriating clearer; and where there are far more restrictions on floor debate, which limits the influence of members who do not sit on Appropriations. The weaker jurisdictional barriers and jealousies in the Senate were illustrated by conference action on the amnesty provisions for illegal aliens. Senate conferees allowed Rep. Mazzoli's cosponsor on the original bill, Sen. Alan Simpson, R-Wyo., into the conference to debate the issue with Rep. Roybal, even though Simpson did not sit on the Senate Appropriations Committee.

The importance of jurisdiction is illustrated by one of the ironies of the discontent of 1987. Neither the president nor Congress really protested the reconciliation bill, which was just as long, if anything more complicated, no better debated, and in the end passed as hastily as the CR. The difference is that the authorizing committees each had their own piece of the action on the reconciliation bill.

Should the Public Object?

The budget pressures that have made continuing resolutions necessary may be avoided in 1988. Convenient economic assumptions — what Ways and Means Committee Chairman Dan Rostenkowski, D-Ill., calls "the big wink" — may allow Congress to meet the deficit reduction requirements of Gramm-Rudman without threat of sequester. It is Reagan's last year in office; the budget agreement he negotiated with Congress is intended to postpone further divisive arguments until after the 1988 elections, when new players might mean a new result. The macro-politics of budgeting just might allow spending bills to pass individually this year.

Even if the elections produce a president and Congress of the same party, however, a need to demonstrate progress on the deficit and factional disputes over whatever measures are taken may push the process back toward an omnibus bill. Some members, like David Obey, D-Wis., say the omnibus part is fine; the difficulty is the rush at the end and the mingling of authorizations and appropriations. Given the natural proclivity to postpone what are sure to be miserable choices, even with a united government Obey's proposal for an early, orderly omnibus bill might still end up late and look a lot like the recent continuing resolutions. We therefore should ask if that trend is so bad.

Is the public represented any worse? Claims that the CR allows a "public interest" in deficit reduction to be overcome by "special-interest" pork are insupportable (never mind that the public may like pork). The CR protects foreign aid appropriations, but there is little pork there —

which is one reason why the foreign aid bill rarely passes on its own! Perhaps agriculture has benefited, but the dollars are small and the merits nowhere near so clear as city-dwellers may believe. The effects of the CR on spending seem marginal at best.

What about authorizations? The accusation that "nobody knows what is in the CR" is less substantive than it sounds. "Nobody knows" what is in most bills. The system works through delegation and cue-giving. Members follow the lead of party leaders or friends on the committee handling a bill. They can get information from an affected group, a congressional caucus, or staffers, all of whom can and do track appropriations just like authorizations. In short, the CR cannot be blamed for creating a process in which most members cannot follow legislation.

Members largely agree, however, that authorizing committees, which have far more members and staff than the Appropriations panels, are better equipped to guide other members about policy. The issue then is whether the CR deprives members of that guidance. On reauthorizations, the Appropriations committees typically follow the existing law and consult with leaders of the authorizing committees. It would be better if reauthorizations were passed separately, but if they are put into the CR, the expertise of the authorizing committees is not lost. When a CR includes a major new authorization such as the 1984 crime bill, it typically already has gone through much of the normal legislative process. The final case, less sweeping authorizations such as the 1987 in-flight ban on smoking, is more of a problem. Yet the process hardly prevented opponents of the ban from making their objections known to their colleagues.

Many members, from authorizing chairmen to backbenchers, want the CR to carry their legislation. The real issue is who decides what goes into the CR. "It's a broad, consultative process," one authorizing chairman commented. "Everybody gets in the act to the best of their ability." Yet the majority party leaders, who broker the process and shape the rule that governs floor debate in the House, have the loudest voice.

When party leaders gain, committee leaders often seem to lose. The CR is used on occasion to get legislation past committee or subcommittee chairmen who blocked its consideration in their panels. The same process can also serve committee chairmen. When reauthorizations are delayed, Appropriations subcommittee chairmen usually work with their authorizing committee counterparts in setting terms for program operation. Support from the latter is Appropriations' best defense against charges it has usurped jurisdictions. These negotiations can give authorizing chairmen and their staffs more influence, vis-à-vis other members, then they might have in the more open, regular legislative process.

The public has little reason to believe that the CR affects policy in any systematic manner. The CR does not prevent members of Congress from discovering and mobilizing to protect their shared interests. Nor is it evident that the CR makes government any less accountable. Aggregating spending choices in general, whether on a budget resolution, a reconciliation bill, or an omnibus CR, increases partisan tendencies and the role of party leaders. Is this good or bad? The average American does not like the sound of "party" and "partisanship." Yet many theorists of

democracy long have argued that only responsible political parties provide the accountability that makes representative government meaningful.

It is clear, however, that the continuing resolution has been the only way Congress could reach agreement on spending decisions during the last few years of budget disputes. It is a good thing we had it. Amid strife over deficits, we tend to forget that the government does things. It tests legal drugs and interdicts illegal ones, feeds the poor and treats their illnesses, builds airports and directs air traffic. In short, it provides for the common defense and promotes the general welfare. The government needs money to operate, and the CR has been the only available conduit.

The *New York Times* has called the current use of the CR "A Crazy Way to Govern America." The 49 Democrats who wrote to Wright said the procedure could "debase the House and Congress in the eyes of the public." Delaying decisions on agency budgets until the fiscal year is nearly a third gone is, indeed, crazy. Delay, however, results from underlying disagreement on the budget, not from the CR. Members of Congress should not feel their institution has been debased by its reliance on a procedure that is more a solution than a problem.

Yet one should not dismiss the concerns of politicians about their institutions. If even the seeming beneficiaries on the Appropriations committees condemn the CR, something must be going on.

There is. The continuing resolution is controversial because it is a centralizing procedure in a system built on separation of powers. When members object to a rather weak trend to consolidate power among one group of members, the Appropriations committees, they express the fact that the trend violates an unspoken precept that in some way all legislators should be equal, so that all citizens are represented equally. Such equality has never been possible, but its functional equivalent has been that every player has a piece of the action. When the House and Senate conferees meet to negotiate the final terms of the CR, they and a few others, primarily the party leaders,

seem to be making the decisions about the entire government. That is not how the system is supposed to work. Many legislatures have inner circles who really run the show; in a parliamentary system that circle is called a cabinet. Our institutions, in particular a separate executive and divided legislature, were intended to prevent such centralization.

Yet budgeting discord and fiscal stress push the system toward some process that reduces the number of players to a few who arrange a comprehensive bargain that the remaining players then sanction. The continuing resolution is our current adaptation to the challenge that budgeting poses for our system of government. As Rep. Barney Frank, D-Mass., commented near the end of the House debate on the CR, "We ought to . . . put the blame where it belongs — on James Madison, because he and his colleagues gave us this uniquely American institution, with separate powers, an independent president, an independent Senate, and an independent House, and that causes problems." Instead of condemning the continuing resolution, perhaps we should ask if the Madisonian system is really "the crazy way to govern."

1. Nearly half of federal spending is for purposes like interest and Social Security, on which administrative discretion is low, policy consensus high, and the political consequences of interruption grave. These receive permanent appropriations. Congress allows the executive to write checks, under clear rules, for very large amounts of money, without annual appropriations.

2. It is not clear that those conditions still prevail. The Democrats' bargaining position, at least from 1982 through 1985, depended on an unspoken assumption that the CR, if vetoed, would be replaced by a stopgap measure setting funding at the previous year's level. While Congress was making big "cuts" in Reagan's defense requests, the figures in the CRs were still well above the level appropriated in the previous year; Reagan therefore had something to gain by signing the CR. In 1987, however, Congress held defense spending to the 1986 level, and there was no credible threat that if Reagan vetoed the CR, Congress would give him even less.

"It is clear, however, that the continuing resolution has been the only way Congress could reach agreement on spending decisions during the last few years of budget disputes."

Expanding the Menu

A Debt-Management Affiliate for the World Bank

Edward R. Fried

ALMOST SIX YEARS have elapsed since Mexico acknowledged it could no longer service its external debt, triggering concern about the safety of the international financial system. As matters have worked out, worst fears have been avoided, but the problem remains serious and stubborn. The total debt owed by developing countries has grown to over \$1 trillion, the interest burden remains heavy despite a fall in rates, and per capita gross national product (GNP) in the most indebted countries is below what it was at the beginning of the decade. Hence the evolutionary case-by-case approach supported by the industrial countries as the most effective route to recovery and creditworthiness continues to be questioned by academic, congressional, and, sometimes, banker critics convinced of the necessity for comprehensive large-scale debt forgiveness.

This article argues that the current debt strategy — not comprehensive debt forgiveness — is best calculated to improve economic performance, which in turn is essential for a satisfactory resolution of the debt problem. Expanded resort to voluntary, selective, and partial debt reduction would strengthen that strategy, and in this the World Bank should have the key role. The proposal here is to create a debt affiliate to be placed within the Bank structure for that purpose.

In fact, international strategy toward the debt problem may now be moving toward a third phase in its evolutionary course. The first, under the leadership of the International Monetary Fund (IMF), emphasized austerity — sharp cutbacks by debtor countries in imports and investment — to bring current accounts under control quickly. With external financing threatening to dry up, no other course short of bailout by the industrial countries could have kept the major players in the game and averted cumulative financial disarray.

Treasury Secretary James A. Baker launched the second phase in the fall of 1985 by calling for the resumption of a growth strategy centered on a drive for economic policy reforms in the debtor countries. Growth and reforms would be supported by increased lending of \$3 billion a year by the World Bank and the regional development banks and \$6 billion to \$7 billion a year in net new lending by the commercial banks.

In the fall of 1987, Baker amplified this strategic framework by suggesting a “menu” of market-based financing options to encourage commercial banks to continue lending to debt-ridden countries. These options include debt conversion techniques such as swapping bank debt at an actual or de facto discount for debtor country equities or new “exit bonds.” Mexico’s recent auction of collateralized bonds in exchange for discounted commercial bank debt also received official blessing under the menu tent. Nonetheless, “debt fatigue” seems to grow among the creditor banks at the very time, ironically, that debtor nations may be on the road to a stronger performance and the multilateral financial

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institutions are gaining additional means to support economic policy improvements in those nations.

For example, in April the IMF's Interim Committee, on the initiative of the United States, approved an External Contingency Facility, which will be able to supply compensatory financing to cushion the effect of a sustained rise in interest rates on IMF-supported adjustment programs. The World Bank is on the way toward a \$75 billion increase in its capital to permit higher lending programs in support of improvements in the economic policies of debtor countries. The Bank is also exploring new possibilities to stimulate private lending through syndicated loans, partial guarantees, and limited cross-default protection.

A new debt-management affiliate for the World Bank would be another step. Its primary purpose would be to expand the use of limited, market-based debt reduction as an integral part of an adjustment program. Inclusion of debt reduction could make the package more attractive to the debtor country and make it easier for money center banks to participate in the financing.

Before examining means and costs, it is good to ask where the debt situation now stands. Is an orderly debt workout still possible? What would it require? Would the alternative strategy of comprehensive debt forgiveness help or hurt present prospects?

The Present Situation

Total external debt of the developing countries is now \$1.2 trillion, about half again as large as it was in 1982. All but 10 percent is sovereign debt, that is, debt guaranteed by the borrowing government. The growth of debt by 7 percent a year since 1982 is less than half the rate of the preceding six years, when private lending to these countries soared. About four-fifths of the total is long-term, of which 60 percent is owed to private lenders, 25 percent to governments of industrial countries, and 15 percent to the World Bank and the regional development banks.

That developing country debt should increase is neither inherently troubling nor surprising. With appropriate policies, investment opportunities at the margin in capital-short countries should be brighter than in capital-rich countries. In that sense, flows from mature to developing economies should maximize returns to capital for the world as a whole. The United States imported capital through most of the 19th century. And before the first oil shock in 1973–74, international accounts consistently showed a substantial capital flow from industrial to developing countries. In recent years, massive U.S. external deficits distorted that picture.

The important questions are how rapidly debt grows and how productively the capital is used, particularly with respect to export industries. If interest payments on debt grow more slowly than exports, debt servicing should proceed smoothly. In the latter half of the 1970s through 1982, debt grew far more rapidly than exports, and the rise in interest rates added to the debt-servicing burden. Because of this debt overhang, the debt-servicing ratios that describe this burden reached very high levels by historical standards and remain high today.

Even so, the size of the total debt overstates the problem, or at least the threat it poses to the international financial system. Some 10 percent is short-term trade finance, which

should be self-liquidating and normally rolls over without too much difficulty. Another 5 percent is owed by the debt-distressed sub-Saharan African countries predominantly to industrial governments and the multilateral financial institutions. Private banks are minor participants. There is clear international recognition that these countries require concessional capital to support policy reform and a breakout from economic decline. Important steps have been taken to supply that capital, specifically, the replenishment of the International Development Association (IDA), the new financing of the IMF Structural Adjustment Facility, and the World Bank Special Action Program in Africa.

About one-third of the debt is owed by countries that as a group still show tolerable debt-service ratios. Interest payments average 7 percent of exports of goods and services, and net new lending (disbursements less repayments of principal) equals some 90 percent of interest payments — which describes a fairly manageable debt picture. These averages cover substantial differences in the positions of individual countries. Korea and Thailand, for example, show strong economic performance. China and India are comparatively recent borrowers on market-related terms. A large component of the debt owed by Poland, Hungary, and Romania has been supplied or guaranteed by industrial countries. In general, three-fifths of long-term debt supplied to countries in this group has come from official rather than private sources. A number of these countries have had to negotiate multilateral debt relief agreements since 1982, but the total debt rescheduled has been fairly small and much of it involved negotiations with industrial governments. Collapse of commodity prices or a sharp setback for the international economy could add dangerously to debt-servicing difficulties, but on the whole these countries have kept clear of trouble.

What is left is the heart of the debt problem — the fortunes of the heavily indebted middle-income countries that were the focus of Secretary Baker's initiative in 1985. Total debt of these 17 countries amounted to an estimated \$485 billion at the end of 1987.¹ Latin American countries (all but 5 of the 17) account for 80 percent of the total. Argentina, Brazil, Mexico, and Venezuela account for more than \$300 billion.

A few key ratios show why the debt position of the heavily indebted group is much more difficult than that of other developing countries. Interest payments in 1985–87 averaged 25 percent of exports of goods and services, more than three times the ratio for other debtors. During the same period, net inflows of capital fell by two-thirds from the preceding three years and were equal to only one-fourth of interest payments (*see table 1*). From the perspective of the private commercial banks, the debt problem is centered in these countries; private banks are the creditors for three-fourths of the total debt of the group.

Is An Orderly Debt Workout Possible?

Economic recovery in the heavily indebted countries, while inadequate, is stronger than generally recognized. Their total annual real growth averaged just under 3 percent from 1985 through 1987, compared with a decline over the preceding three years. Growth is still down by more than one-third from potential, as measured by performance

during most of the 1970s, and per capita income, now beginning to grow, is still 10 percent below the 1980 level. Economic policy improvements and results vary among the countries, disappointing in some, promising in others. Data for the group as a whole show a moderately encouraging trend, particularly for debt-servicing capacity (see table 1).

Even though total debt has continued to increase, the ratio of interest payments to net exports began to level off in 1984 and then declined sharply in 1987. The ratio of interest payments to GNP — an important measure of the debt-service burden — fell significantly in each of the past three years. Moreover, these improvements, as well as the partial recovery of economic growth, were achieved during a period in which the terms of trade deteriorated. IMF calculations show that between 1979 and 1987 the impact of adverse changes in terms of trade on the capital-importing developing countries amounted to \$52 billion. Nonetheless, the current account of these countries strengthened dramatically — moving from a deficit of \$50 billion in 1979 to a surplus of \$3 billion in 1987. Thus, the tightening measures taken by the debtor countries were twice as difficult to carry out as they would have been in a neutral terms-of-trade situation. If growth in the industrial countries remains stable or improves, the developing countries should receive economic and debt-service help from some recovery in commodity prices from their lows in the first half of the 1980s.

Experience so far leaves the underlying rationale for the current growth-oriented debt strategy intact.

— There is no alternative to adjustment. Pressure for policy reform in the debtor countries will continue because reform is the major means for mobilizing investment resources and using them more efficiently. Higher growth is impossible without improved policies.

— The World Bank, working closely with the IMF and

the regional development banks, must be the key outside force promoting adjustment, country by country. To do this, it will have to be a major, assured source of external finance. Carrying out one function without the other is a prescription for failure.

— Private banks will have to roll over existing debt for the foreseeable future and supply new lending equal to a significant share of interest payments. They can use various kinds of debt-conversion techniques to discount part or all of their outstanding loans. Conversions would relieve them of new lending responsibilities to the extent that debt reduction decreases the interest payment obligations of the debtor countries. Failure of the banks as a group to participate along these lines in adjustment programs would trigger widespread interest arrearages if not debt repudiation, which would worsen the position of both the banks and the debtor countries.

— Higher levels of economic growth and a lowering of trade barriers in the industrial countries would hasten the return of debtor countries to creditworthiness. A recession or, most dangerously, a swing toward protectionism would jeopardize growth and debt-servicing capacity in the heavily indebted countries.

— Achieving economic recovery and a return to creditworthiness will take more time than originally thought. Progress has fallen short of expectations, increasing the danger of flagging efforts on the part of debtor governments and creditor banks. A premium exists on devising additional financing techniques that will improve confidence in the strategy, encourage stronger adjustment action, and ensure financing to support it.

What would a stronger recovery require? A recent World Bank study, based on a country-by-country analysis, provides a useful, quantitative perspective.² The Bank estimates that most of the heavily indebted countries could achieve 4-5 percent annual growth over the next three

Table 1. Economic Growth and Key Debt Ratios in Heavily Indebted Countries

	Average 1978-81	1982	1983	1984	1985	1986	1987
Growth in gross domestic product	4.3%	-0.6%	-2.9%	2.3%	3.0%	3.1%	2.5%
Interest (in billions)	\$ 21.4	\$ 40.7	\$ 38.9	\$ 40.1	\$ 38.7	\$ 34.4	\$ 32.1
Net flows (in billions)	\$ 31.5	\$ 34.6	\$ 21.6	\$ 15.6	\$ 6.4	\$ 4.8	\$ 13.0
Key Debt Ratios							
Debt to GNP	33.6%	45.6%	56.3%	56.7%	57.6%	59.6%	58.0%
Debt to exports	186.7	254.2	286.4	267.4	282.3	335.6	317.9
Debt service to GNP	5.8	7.9	8.0	7.8	7.5	6.9	6.2
Debt service to exports	32.4	43.9	40.6	36.9	36.9	39.1	34.1
Interest to GNP	2.7	4.8	5.4	5.4	5.1	4.5	3.9
Interest to exports	15.3	26.9	27.2	25.4	25.2	25.3	21.4
Net flows to GNP	4.0	4.1	3.0	2.1	0.8	0.6	1.6

Source: "World Bank Operational Strategy in the Heavily Indebted Middle Income Countries," March 9, 1988.

Notes: The figures exclude the effects of interest arrears. Net flows equal newly disbursed lending minus repayments of principal.

Table 2. Net External Financing for Heavily Indebted Countries: Requirements and Sources
(billions of dollars, annual averages)

	1982-84	Actual 1985-87	Projected Requirements 1988-90
Net financing required			
Current account deficit	\$22.7	\$ 8.9	\$14-15
Addition to reserves	-2.7	2.0	2
Total	20.0	10.9	16-17
Sources of financing			
Private investment	4.2	3.4	2-3
Bilateral aid, official transfers	1.8	1.7	1-2
Net IMF financing	4.0	0.4	^b
Change in short-term credit	-12.7	-9.5	—
Medium/long-term financing	23.0	8.1	11-14
World Bank/IDA	2.6	2.8	3
Other regional development banks	1.1	1.4	1
Bilateral creditors	1.4	0.9	1
Private creditors	18.0	3.0	6-9
Statistical discrepancy ^a	-0.4	6.8	—

Source: "World Bank Operational Strategy in the Heavily Indebted Middle Income Countries," March 9, 1988.

^a Includes capital not included elsewhere, reserve valuation adjustments, and errors and omissions.

^b Prospective net financing through use of IMF resources cannot be estimated because it depends largely on the number and amount of new money arrangements that may be agreed to in the future.

years under these conditions: (a) adoption of "significant though realistic policy improvements in many countries and sustained good policies in others"; (b) economic growth of 2-2½ percent a year in the industrial countries, which would be modest on present expectations, and avoidance of an interest rate shock; and (c) net capital inflows sufficient to finance an average current-account deficit for the group on the order of \$14 billion to \$15 billion a year and additions to reserves of \$2 billion a year. Even at the projected growth rates, the debt overhang would remain a serious problem. Nonetheless, the heavily indebted countries would experience an increase of 1-2 percent a year in per capita income and show steady improvement in debt-servicing ratios — the two requirements for an orderly debt workout and an eventual return to creditworthiness.

Of these conditions, strengthened adjustment policies and the key role of the World Bank in helping the heavily indebted countries to adopt them already have been stressed. How stiff are the external financing requirements and what are the prospects for realizing them? Possible financing sources and what the World Bank projects each source might supply over the period 1988-90 compared with actual experience in recent years is shown in Table 2.

Net external financing of \$16 billion to \$17 billion a year is by no means an outsized figure. While \$6 billion above the 1985-87 level, it is \$11 billion below the average for the preceding three years. Projections for some major elements are either modest or assured. Private investment flows of \$3 billion are low by past standards; the flow could be

significantly higher if policies continue to move toward privatization and greater reliance on market-based incentives and resource allocations. The \$75 billion capital increase will make it possible for the World Bank to lend the projected \$3 billion a year if improved policies justify the loans. And no allowance is included for a reversal of capital flight from these countries, which the World Bank estimates is now \$9 billion a year.

Clearly, net new lending by the commercial banks is the major financing uncertainty. The projected level of \$6 billion to \$9 billion a year is about the same as the objective Secretary Baker set in launching the growth-oriented debt strategy in 1985. In fact, however, average net private lending, 1985-87, fell sharply to \$3 billion a year, equal to only 15 percent of interest payments due on outstanding loans. In the three years following the onset of the debt crisis, 1982-84, net new private lending to the highly indebted countries averaged \$18 billion a year, equal to 90 percent of interest payments. Also, by contrast, net lending from public sources (World Bank, regional development banks, IMF, and industrial countries) has held up fully since 1982 and amounted to 50 percent more than interest payments on their outstanding loans. The attempt at disengagement by private lenders, while unfortunate and inherently self-defeating, is understandable in view of their massive exposure and the pressures they are under to increase provisioning against troubled loans. And it does not justify the allegation that the maintenance, or increase, of official lending serves only to bail out the commercial

"... the main purpose of public lending is not simply to supply external resources but to encourage policy reforms essential to the [economic] recovery ... in these countries."



banks, since these banks continue to be net new lenders, although on a greatly reduced scale. Furthermore, the main purpose of public lending is not simply to supply external resources but to encourage policy reforms essential to the recovery of trend economic growth in these countries.

Nonetheless, the fact remains that a reversal in this downward trend in private lending — a fairly modest reversal under World Bank projections of requirements — is necessary to avoid jeopardizing further economic recovery in the heavily indebted countries. For the same reason, failure by the commercial banks to increase net lending would narrow, if not eliminate, the possibilities for a gradual, orderly debt workout, which in the end is the most effective means for containing their damage.

Is Comprehensive Debt Forgiveness Helpful? Feasible?

Projected requirements of \$8 billion a year in net new commercial bank lending would be equal to approximately 40 percent of current interest payments on outstanding

long-term private debt of the highly indebted countries. Thus a writedown or forgiveness of that proportion of the total private debt would save \$8 billion in interest payments and have the same financing effect as \$8 billion a year in net new lending. It would also make the debt picture look much less formidable, not only in total size but in sustainability, as the various debt-servicing ratios would show instant improvement.

The impact on economic growth would be less clear. On the one hand, if the reduction in interest payments came at the expense of new lending, the availability of external capital would not improve and might even be reduced, certainly over the longer term. Private foreign direct investment might be stimulated because the debt writedown could reduce fears of restrictions on profits and capital repatriations. Politically, the effect on adjustment could go either way. The writedown might be seen as giving a government additional ammunition to overcome obstacles to policy reform or, alternatively, as concentrating a government's effort on obtaining debt relief at the expense of attention to policy reform. On the other hand, if the

commercial banks, debtor governments, and industrial countries (which in the end would have to be involved) agreed on a comprehensive large-scale writedown and proposed to resume normal financial relations afterwards, economic recovery in the highly indebted countries would receive new impetus.

This reasoning, along with despair about achieving improvement under the current case-by-case approach, has led to a number of proposals for comprehensive forgiveness as the only way out of the debt problem. The steady decline in open market prices of commercial bank loans to the highly indebted countries supposedly adds to the argument. In the past year, average prices have fallen from roughly 65 percent to 50 percent of face value. Comprehensive debt writedowns, it is argued, would merely recognize market realities. If these debts were exchanged for suitably guaranteed bonds at, for example, 60 percent of face value, the commercial banks as well as the debtor countries would share the discount and benefit.

Several reasons explain why commercial banks—at least those with major exposure—have been unable to work up much enthusiasm. At a discount of one-third, for example, they would be writing down \$90 billion in long-term loans to the heavily indebted countries. In the case of the U.S. money center banks, such a writeoff would amount to more than half their primary capital at the very time they are being required to increase capital. Even after allowing for tax benefits and the phasing of writeoffs, the consequences to the financial position of these banks would be substantial.

Nor is the underlying justification for comprehensive debt forgiveness self-evident. Market prices for these bank loans are certainly unreliable as a measure of the prices the large creditor banks would accept for their loans. More fundamentally, who draws the line between debtor countries that could make it without writedowns and those that cannot, and on what basis? If Korea and Turkey could take effective adjustment action to become creditworthy, why not potentially high-growth countries like Brazil and Mexico, which together account for 40 percent of the long-term private debt of the heavily indebted countries? What would be the effect of a sustained, though gradual, rise in oil prices on the debt-servicing capacity of Venezuela, Nigeria, and Mexico? On what basis would large debtors outside the heavily indebted countries—Indonesia and Malaysia, for example, or Poland, Hungary, and Romania—be excluded from writedowns? Who could determine the appropriate discounts in the absence of reliable markets?

Ultimately, industrial countries would have to support comprehensive debt relief, and thus far the major countries at least are strongly opposed for several reasons.³ First, these governments would have to force the commercial banks to participate through regulatory or tax pressures, which the governments would be reluctant to do. Also, such action could be subject to legal challenge by the banks.

Second, in these proposals, the industrial countries are the guarantors, direct or indirect, of the written-down debt taken over from the commercial banks. This contingent credit risk might reasonably be viewed as moderate, but only if new lending and adjustment policies after the writedown are systematically monitored. Industrial countries would also find the creation of new agencies or

entities envisaged in some proposals to be cause for concern. Outside influence needs to be concentrated, not diluted, specifically by increasing the ability of the World Bank to promote effective adjustment.

The Debt Affiliate Option

Many of the troublesome questions raised by comprehensive forgiveness approaches are resolved by debt reduction techniques that are market-based, voluntary, and integrated with adjustment programs as part of the current debt strategy. Examples, as noted earlier, are debt-equity swaps, exit bonds issued by debtor governments, and Mexico's auction of long-term bonds whose principal is secured by long-term, zero-coupon U.S. Treasury bonds.

Thus far only debt-equity conversions have been quantitatively significant: the World Bank estimates they amounted to \$8 billion in the past three years. Exit bonds, used in the 1987 Argentine debt restructuring plan, were limited in size and introduced only to permit banks with small exposures to avoid new lending obligations by accepting reductions in interest payments. Mexico's bond auction was only a modest success, partly because interest payments on the bonds were not externally guaranteed. Use of the Mexican technique, moreover, is restricted to debtor countries able and prepared to use scarce foreign exchange up front to collateralize the bonds.

Bringing the World Bank directly into the process could greatly expand the use of partial, selective debt reduction as an effective adjustment technique. The Bank could best be involved by establishing a debt-management affiliate. With such an affiliate, the World Bank could offer to negotiate debt reduction covering a portion of a country's long-term debt to commercial banks as part of an adjustment package arranged with that country. Reductions in

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debt and interest payments under this procedure would be smaller than those under comprehensive forgiveness proposals covering countries' total long-term debt. But World Bank offers could improve prospects for adequate new commercial bank lending and be attractive enough to strengthen the position of debtor governments for overcoming domestic obstacles to policy reforms.

Specifically, the technique would work as follows:

- In negotiating adjustment measures and financing with a debtor country, the World Bank would offer to exchange at a discount up to a designated amount of long-term commercial bank loans to that country for the long-term bonds of the new Bank affiliate. The exchange would take place in tranches, or sections, with each dependent on progress made in policy reform. The World Bank would then exchange the discounted commercial bank loans for obligations of the debtor country.

- The World Bank would determine the discount by auction, along the lines of Mexico's bond auction. It would exchange up to a specified amount of the bonds of its affiliate to those creditor banks bidding the highest discounts on their loans to the country concerned. Offers of less than a minimum discount — for example, one-third — would not be accepted. Low discount offers in the initial auction or a decline in discounts bid in subsequent auctions would signal an improvement in creditworthiness and a diminished need for debt conversion for the country concerned — in short, progress toward resolution of the debt problem.

- Commercial banks exchanging their loans at a discount would be relieved to that extent of obligations to participate in new lending programs to that country. Thus they would be able to replace debtor country loans on their balance sheet with World Bank affiliate bonds and write off the discount as a loss.

- Commercial banks with smaller exposures would be most anxious to close their books on these loans and offer the largest discounts. At a discount of at least one-third, their action would be equivalent to participating in concerted new lending requirements of the size projected by the World Bank as needed over the next three years.

- Because of quantitative limits on the exchange offer, money center banks could dispose of only a small portion of their loans, if they chose to do so at all. However, their position would improve for three reasons. First, a major reduction in the number of "free-riders" (smaller banks who refuse to participate in new lending but who insist on collecting interest in full on old loans) and in the number of participating banks would make it easier to negotiate new lending requirements. Second, demand from the World Bank auction probably would increase market prices for the outstanding debt. Third, negotiations with debtor countries would be less time consuming and relations more productive.

- Reductions in the debtor country's interest payments and debt would depend on the amount of the exchange and the size of the discount. If, for example, a maximum of one-fourth of the total debt of each country were auctioned off and all the heavily indebted countries eventually negotiated adjustment packages with the World Bank that included such auctions, the group's total debt would be reduced by some 10 percent and interest payments by approximately \$2 billion a year. Debt reduction on this

scale would be politically helpful to these governments in overcoming adjustment fatigue and staying on an orderly debt workout course.

Industrial countries and the capital-surplus oil-exporting countries would have to back the bonds of the affiliate and would control its operations. How might this be done and what would it cost?

To continue with the above example, assume that the affiliate had authority to issue bonds covering one-fourth of outstanding long-term commercial bank loans to the heavily indebted countries. A maximum of about \$75 billion would then be subject to the auction procedure. If these loans were exchanged at a discount of one-third, required bond issuing authority would be \$50 billion.

World Bank bonds are backed by all member countries, with two-thirds of the capital subscribed by industrial countries. In the recently negotiated capital increase of \$75 billion, 3 percent is to be paid in and the balance callable on need. The World Bank has never found it necessary to make a call on unpaid capital; in fact its paid-in capital from past subscriptions is unimpaired, and the Bank has accumulated a reserve of \$7 billion from earnings. World Bank lending power, moreover, is conservatively limited by its charter to no more than its subscribed capital and reserves. As a result of this financial structure, World Bank bonds sold on international financial markets to finance its loans carry the top rating.

The affiliate could be authorized to issue bonds equal, say, to twice the amount of its subscribed capital, since all of this capital would be subscribed by high-income countries, and the assets the affiliate would exchange for its own bonds — namely the obligations of debtor countries — would have implicit senior status as do all obligations owed to the World Bank. On that basis, the affiliate would require capital subscriptions of \$25 billion, of which 5 percent might be paid in over six years, the schedule used for the paid-in portion of World Bank capital subscriptions.

In apportioning capital subscriptions among the countries backing the affiliate, account should be taken of current international payment positions and the obligation of countries with strong surpluses to contribute proportionately more to the recovery of world economic growth and trade, particularly to the revival of the debt-troubled middle-income economies. Japan, then, might subscribe 50 percent of the required capital for the affiliate, the European Community 30 percent, the United States 10 percent, and other high-income countries 10 percent. Voting rights in the affiliate would be proportionate.

The contingent liability of ultimate default by debtor countries — not the comparatively small budgetary appropriations for paid-in capital — would be the predominant obligation underlying these capital subscriptions. The continuing involvement of the World Bank, through conditional lending and technical advice, would be major insurance against default. That is why the capital increase of the World Bank has such high priority and why the U.S. subscription should not be hostage to the exploration of debt relief possibilities, as some members of Congress who normally support the World Bank unfortunately are seeking to do. That is also why new debt reduction instruments should be made part of the World Bank adjustment arsenal and structure, not established in new independent entities.

Establishing an affiliate would require new legislation, which would take time, particularly in the United States. Time could be saved if the proposal were the product of a joint executive-congressional initiative, building on preparatory work already done in Congress. Internationally, discussion at an economic summit and among the Group of Seven finance ministers would expedite matters, particularly since only the high-income countries would subscribe capital.

In view of the delay, however, why is an affiliate needed? Why not have the World Bank do the job with the new lending power gained by the increase in its capital? The answer is that this additional capital is needed to underwrite the World Bank's increased lending program, half of which is slated to be in the form of structural adjustment or policy-based lending. This lending program is essential to the mobilization of external financing requirements and to the success of adjustment measures themselves.

Establishing an affiliate, moreover, makes it possible to include features useful for the debt problem but not provided under the World Bank charter. There is ample precedent for this. The International Development Association was established in 1960 to enable the World Bank to make grant-like loans to low-income countries, which could not service World Bank loans on market-related terms. Similarly, the International Finance Corporation was established in 1956 as an affiliate of the World Bank to make loans and take equity positions in the private sector. In each case, apportionment of capital subscriptions and voting power are different from what they are in the World Bank. A debt-management affiliate could be established with its own limits on bond-issuing authority in relation to capital and might include insurance, loan guaranty, and other provisions that were found to be useful to facilitate new lending to the highly indebted countries.

In any event, the most urgent need is to facilitate economic improvements that are now in prospect under the present debt strategy. Vulnerabilities are evident. Among the most serious are flagging enthusiasm for policy reform on the part of debtor governments and disengagement on the part of creditor banks. Both would be self-defeating. Renewed effort is required on the part of debtors and creditors alike, which in turn needs the encouragement of an expanded World Bank role.

What has been suggested here should be seen as a supplement to Secretary Baker's menu approach. No one course of action could conceivably be sufficient. Establishment of a World Bank debt-management affiliate together with other means being developed for dealing with debtor country payment burdens would be an important step in coping with debt problems.

1. Secretary Baker's list consists of 15 countries: Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Ivory Coast, Mexico, Morocco, Nigeria, Peru, Philippines, Uruguay, Venezuela, and Yugoslavia. The World Bank adds Costa Rica and Jamaica.

2. "World Bank Operational Strategies for the Heavily Indebted Middle Income Countries," March 9, 1988.

3. The finance ministers of the Group of Seven "reiterated their strong opposition to global debt-forgiveness proposals that transfer risks from the private sector to the international institutions or creditor governments" at their meeting of April 13, 1988, in Washington, D.C.

"Vulnerabilities are evident. Among the most serious are flagging enthusiasm for policy reform on the part of debtor governments and disengagement on the part of creditor banks. Both would be self-defeating. Renewed effort is required on the part of debtors and creditors alike, which in turn needs the encouragement of an expanded World Bank role."

A Global Bandwagon

LARGELY AS A RESULT of the success of tax reform in the United States, many other countries are giving serious attention to reforming their own tax systems. Among the reforms under consideration or already enacted in some cases are rate reductions, measures to broaden the income tax base, imposition of a value-added tax, and changes in corporate taxes.

Developments in these countries are occurring so quickly that few people can keep track of them. Yet, as Joseph A. Pechman points out in his introduction, knowledge of these changes is essential for intelligent business and government tax planning. "The changes taking place will profoundly affect the distribution of tax burdens, as well as important domestic economic variables such as labor supply, saving, investment, growth of productivity, and exchange rates," he writes. "The changes will also affect the competitive position of business firms in world markets and the flow of investment funds among nations."

In *World Tax Reform*, senior government officials and tax experts from 11 countries—Australia, Canada, Denmark, France, Great Britain, Italy, Japan, the Netherlands, Sweden, West Germany, and the United States—evaluate the tax revisions contemplated by their governments. Pechman, the editor of the volume and the author of several books on tax policy, is a senior fellow in the Brookings Economic Studies program.

World Tax Reform: A Progress Report

Edited by Joseph A. Pechman
\$11.95 paper

Brookings Dialogues on Public Policy

World Tax Reform A Progress Report

Edited by
Joseph A. Pechman



Learning from Past Failures

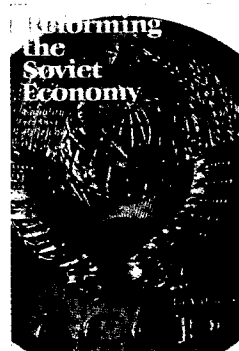
WHEN MIKHAIL GORBACHEV assumed the post of general secretary of the Communist Party in March 1985, he inherited a Soviet economy overripe for reform and a population eager for change. He has set himself to the task with an enthusiasm and a vision that have captured the attention of the world. Gorbachev understands the narrow, primarily military, foundations on which Soviet superpower status rests, and he is clearly concerned about the long-term viability of such a posture. His response has been a program for military, economic, political, and social reform that if fully implemented, will match Lenin's revolution in its implications for the USSR and for the rest of the world. In *Reforming the Soviet Economy*, Ed A. Hewett analyzes these reforms and their likely consequences for the performance of the Soviet economy in the 1990s.

Hewett examines the strengths and weaknesses of the Soviet economy during the last quarter century, drawing a clear picture of a system that has offered tremendous economic security to the population but at a substantial cost in economic efficiency. Hewett views Gorbachev's reforms as the latest in a series of efforts to reform the economic system Stalin bequeathed to Soviet society. Previous efforts also reflected a concern over how to improve efficiency without threatening the economic security that underpins the party's rule. Hewett's analysis views the recent reforms in light of what Gorbachev says he intends to do, what he has actually done, and whether there is any clear indication that Soviet leaders have learned from the failures of past reform efforts.

Hewett is a senior fellow in the Foreign Policy Studies program at Brookings. He is the author of *Energy, Economics, and Foreign Policy in the Soviet Union* (1984) and editor of the journal *Soviet Economy*.

Reforming the Soviet Economy: Equality versus Efficiency

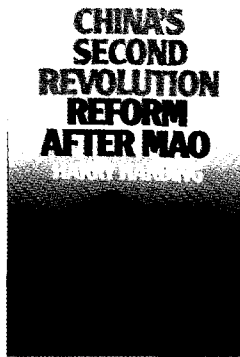
By Ed A. Hewett
\$16.95 paper; \$36.95 cloth



Breaking with the Past

China's Second Revolution: Reform after Mao

By Harry Harding
\$12.95 paper; \$32.95 cloth



SINCE MAO ZEDONG DIED in 1976, the scope and pace of reform in China has exceeded what most observers, Chinese and foreign alike, thought possible. The result of extraordinary political engineering by a coalition led by Deng Xiaoping, the reforms have given the Chinese people more autonomy from the state, allowed greater political and intellectual activity, given government officials and economic managers greater autonomy from the Chinese Communist Party, and loosened central planning for economic activity. In *China's Second Revolution*, Harry Harding, a senior fellow in the Brookings Foreign Policy Studies program, looks at the origins of these reforms, their successes and failures, and their prospects for survival in the post-Deng period.

Several hurdles must be crossed if the reforms are to last. First, the Chinese leadership since Mao has undertaken only the most popular reforms; "many of the politically controversial reform measures most essential to the success of the overall effort are yet to be implemented," Harding writes. Second, some reformers have placed even more radical changes on the political agenda. These reforms, which would create markets for land, capital, labor, and technology, institute new forms of state ownership of urban industry, and permit some degree of political pluralism, are thus far unacceptable to more conservative leaders and could in time split apart the coalition of reformers. China's modernization will also create new tensions internationally, although Harding does not foresee these strains resulting in a systemic political crisis, a sustained cold war, or acute economic competition.

Mixing Oil and Water

Uneasy Compromise: Problems of a Hybrid Income-Consumption Tax

Edited by Henry J. Aaron,
Harvey Galper, and
Joseph A. Pechman
\$14.95 paper; \$34.95 cloth



Problems of a
Hybrid Income-
Consumption Tax

HENRY J. AARON, HARVEY GALPER,
AND JOSEPH A. PECHMAN, EDITORS

TAX EXPERTS have debated for decades whether the nation would be better served by an income tax or a consumption tax. In practice, tax systems everywhere are mixed or "hybrid" systems. And while legislators have reasons for enacting such systems, the mix results in inequities, inefficiencies, and abuse.

For *Uneasy Compromise*, Brookings brought together some of the nation's most knowledgeable tax experts and analysts to address the question: How should lawmakers grapple with the problems that arise from the side-by-side existence of principles of consumption taxation with principles of income taxation? Rather than propose rules for an ideal system that will never exist, the book addresses specific problems created by a hybrid system. Among those issues are the cost of capital, interest deductions, savings incentives, investment incentives, indexation, and minimum taxes. By examining each of these subjects, the book offers a comprehensive analysis of the current tax system and the tools for evaluating proposed refinements.

Henry J. Aaron and Joseph A. Pechman are senior fellows in the Brookings Economic Studies program. Aaron is also professor of economics at the University of Maryland and coauthor most recently of *The Comparable Worth Controversy* (1986). Pechman recently revised his classic study, *Federal Tax Policy* (1987), and edited *World Tax Reform* (1988). Harvey Galper is a former senior fellow in the Economic Studies program and coauthor with Aaron of *Assessing Tax Reform* (1985).

Candidates and Campaign Styles

AS STEPHEN HESS writes, the process we use to select our presidents "has been criticized as encouraging the survival of the unfittest, as wearing out the voters and thus discouraging their attention, as being too focused on political sparring and not enough on issues, and as obscuring any possible perception of candidates' potential mettle." In this third edition of *The Presidential Campaign*, Hess explores the validity of these and other contentions.

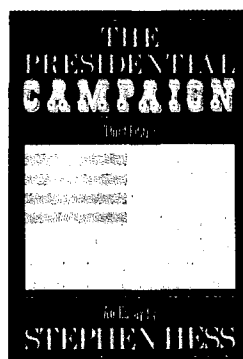
His conclusions are sobering. Hess casts a wary eye on political rituals and proposed reforms, often pointing out the ways in which the most criticized practices — the long campaigns, for example — may benefit the electorate. Unlike most political scientists and political journalists, Hess believes that change in the selection process will not fundamentally change the results, that regardless of the different schemes that have been proposed for choosing presidential nominees, the process will come up with essentially the same type of person as in the past.

Hess is a senior fellow in the Brookings Governmental Studies program. He has been an adviser to four presidents and is the author or coauthor of several books on the presidency and on the media. For this third edition, Hess has substantially revised the study to incorporate the experience of the 1980 and 1984 elections.

The Presidential Campaign, Third Edition

By Stephen Hess

\$8.95 paper; \$22.95 cloth



Mergers: How Successful Are They?

DESPITE THE RASH of mergers and acquisitions in the 1980s, debate continues over one key question: What are the consequences of mergers and takeovers for the subsequent performance of the companies involved? In their new book, *Mergers, Sell-Offs, and Economic Efficiency*, David J. Ravenscraft and F.M. Scherer move toward a definitive answer. Using stock market information, case studies, and finely segmented "line of business" data to analyze the precursors and results of some 6,000 manufacturing industry acquisitions by 471 corporations between 1950 and 1976, the authors conclude that more often than not, serious errors were made both by managers and by the investors who provided major financing.

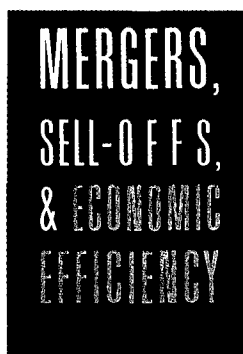
Before merger the typical acquired company had profitability well above the average for its home industry. After merger the sample divided into two groups. Approximately one-third of all acquisitions were subsequently sold off; on average these merged lines had negative operating income during the last year before they were sold. The remaining two-thirds were what Ravenscraft and Scherer call "survivors." Their profitability also tended to decline, most significantly in purely conglomerate acquisitions and when relatively small companies were acquired. The exceptions, those with slightly improved profitability, were mergers of roughly equal-sized companies.

The authors supplement their extensive statistical analyses with 15 case histories of merger and sell-off. They conclude with a chapter on implications for theories of merger, for the management of merger activity, and for public policy. Ravenscraft is associate professor of business administration at the University of North Carolina at Chapel Hill. Scherer is Joseph Wharton Professor of Political Economy at Swarthmore College.

Mergers, Sell-Offs, and Economic Efficiency

By David J. Ravenscraft and F.M. Scherer

\$12.95 paper; \$32.95 cloth



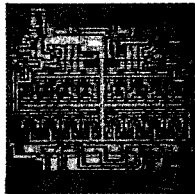
Economic History of a High-Tech Advance

Creating the Computer: Government, Industry, and High Technology

By Kenneth Flamm
\$10.95 paper; \$28.95 cloth

Creating the Computer

Government, Industry,
and High Technology



KENNETH FLAMM

"THE COMPUTER," Kenneth Flamm writes in his new book, "is arguably the most economically important technological innovation of this century." In *Creating the Computer*, Flamm provides a new understanding of the complex forces that have shaped the computer industry since its beginnings in the 1940s. Flamm identifies the origins of technologies important to the creation of computers, traces the roots of individual technologies to the specific research groups and programs responsible for major advances, and evaluates the impact of these innovations on industrial competition. Flamm argues that key factors defining this competition were the emergence of specialization and product differentiation in the 1950s and of compatibility and standards in the 1960s.

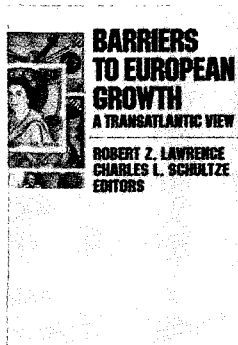
Flamm documents the role of government support for technology in the United States, Western Europe, and Japan and describes the critical technological and economic links between national and international markets. Finally, he shows how these market strategies, technological trends, and national policies continue to influence development in the computer industry. "The development of the computer industry," Flamm concludes, "may be remembered as much for exemplifying a new pattern for economic growth, as for the world-shaking technology that it accidentally unleashed on us all."

This book is a companion volume to *Targeting the Computer: Government Support and International Competition*. Flamm is a senior fellow in the Brookings Foreign Policy Studies program.

Assessing Europe's Economic Problems

Barriers to European Growth: A Transatlantic View

Edited by Robert Z. Lawrence and
Charles L. Schultze
\$18.95 paper; \$39.95 cloth



WHILE ECONOMIC PERFORMANCE deteriorated in industrial countries after 1973, the distinguishing feature of the European experience has been the behavior of unemployment. For Europe as a whole, the jobless rate has risen in almost every year since 1973 and now stands at 11 percent of the labor force. This new book, *Barriers to European Growth: A Transatlantic View*, represents a joint undertaking by a group of American and European economists to understand the causes of high unemployment in Europe and to offer some policy suggestions.

In this volume, American experts examine various aspects of the European economies, including labor and financial markets, budget policies, industrial structures, and international competitiveness. Their findings were first presented at a conference held at Brookings, where each paper was evaluated by a group of European economists. Both the papers and the critiques are included here. The book's editors summarize the findings and offer recommendations in the book's overview chapter.

Robert Z. Lawrence, a senior fellow in the Brookings Economic Studies program, is coauthor of *Saving Free Trade: A Pragmatic Approach* (1986) and author of *Can America Compete?* (1984). Charles L. Schultze, director of Economic Studies, is author of *Other Times, Other Places: Macroeconomic Lessons from U.S. and American History* (1986) and *The Public Use of Private Interest* (1977).

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